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NEW CANADIAN INSURANCE COMPANIES ACT

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Recorder: W. STEVEN PRINCE

- Problems of compliance for foreign insurers.

MR. W. STEVEN PRINCE: The approach we have taken for this session assumes that the audience would be primarily American. Any Canadians in the audience may have heard this before. For the Americans in the audience who missed the joke, we have the current president, the president-elect, and the immediate past president of the Canadian Institute of Actuaries sitting here looking for the errors that we have carefully hidden.

I'm the appointed actuary for both the branch and the Canadian subsidiary operations at New York Life in Canada. My career has generally been with insurance companies except for a brief flirtation with consulting.

My other panelist, Paul Winokur, is a consultant with Eckler Partners in Toronto, a member of the Woodrow Milliman International Group. He's been in the business 20 years, 13 years in consulting. He's served as a councillor and a vice president of the Canadian Institute of Actuaries. He's also on some of the committees that we'll be referring to in this presentation.

I'm currently Chairperson of the Life Practice Committee of the Canadian Institute of Actuaries, which we'll refer to. And if anyone is taking notes for next time, I was one of the high quality, but unsuccessful, candidates for the Board of Governors that Daphne Bartlett was talking about. So, with that introduction, we will move on.

The recent Insurance Companies Act in Canada was the first sweeping overhaul of life insurance legislation in Canada since the 1930s. The Act included extensive changes in corporate governance, corporate powers and investment policies of companies. Whole sessions could be devoted to each of these topics. In fact, I think the total content of the last couple of years at the Canadian Institute meetings would be required to cover all of this.

This session is going to confine itself to topics of interest to actuaries. As I mentioned, we're presuming you are foreigners and you're wondering what's going on in Canada. From my own perspective, New York Life's operation branch is still run on U.S. systems. We had to build patches between the U.S. administration systems and our Canadian valuation systems to do the compliance matters. The subsidiary runs on separate stand-alone computers. We probably spend more money than we would like to in tying the system together to produce consolidated statements.

The Canadian operation is medium-sized by Canadian standards, and it's a small percentage of the total worldwide operations of New York Life.

Now I will give an overview of the legislation. One of the major thrusts of the legislation is that it's expected there will be a significant consolidation and homogenization of the insurance industry and the financial services industry in Canada, over the next two years. Consolidation means there are expected to be far fewer players. Currently, there are around a 160 life insurers in Canada, and that number seems to be falling by the week. There are four or five major banks in Canada and a couple of hundred property and casualty (P&C) companies. Traditionally, these have been what we used to call the "four pillars of the financial services," which legally designated the spheres of operation. Those pillars are crumbling, and it's expected that in ten or 15 years there might be a dozen to three dozen consolidated financial institutions that offer a full range of financial products. Homogenization of companies means that they will be offering increasingly similar products. Much of the product ingenuity that you see currently on both sides of the border will become unnecessary. You simply sell whatever it was you wanted to sell and call it that and away you go.

The new Act also implemented Canadian GAAP with something called policy premium method (PPM) reserves, and I'll be expanding on that. And finally, at some local branches, although it was optional last year, it is no longer optional for Canadian statements to file on a Canadian basis. Previously, you could file on a U.S. basis, then have your actuary do a study to show that the U.S. reserve is at least as big as the Canadian requirement. You were home free. But as of this year-end, it's not an option. You have to file proper Canadian statements, and of course, that means more work for consulting actuaries in Canada, if you could find them.

There are several new powers granted to and obligations imposed upon the appointed actuary, and I'll expand on that. Both Paul and I attended a session on whether or not the U.S. appointed actuary role was on the right track, and we'll be making some comments on the comparisons between the two. Neither of us practices in the U.S., so our observations will be limited.

Another point of some interest, not just to actuaries, is offshore data processing. It used to be that you could set up a branch in Canada and run everything through your U.S. computers. That situation made sense to everybody. Your objective was to have a large efficient operation with minimal incremental cost to operate in Canada. That's no longer a given. You need special permission from the Office of the Superintendent of Financial Institutions (OSFI) to operate any data processing and record keeping outside of Canada. Now, that's significant. OSFI's concern is that, if your company is in trouble or your branch is in trouble, OSFI needs to be able to step in on fairly short notice and take over. It needs to have enough hardware and software here to do the job. Many people will say, well, great. When we get to be in trouble, we'll talk. OSFI's approach is, well, when you get to be in trouble, it's going to be too late to talk. So, OSFI is making this requirement of everybody.

So far, it doesn't seem to be a big problem. A major company, such as mine, and several others have simply said, well, we'll keep copies of all the records here. We'll keep them updated on a regular basis, and you can step in and take those at any time. We and the rest of the industry made special requests to OSFI close to a year ago asking for this exemption. Most of us have not heard back one way or the other, which we are certainly taking as consent until they tell us otherwise. So, you may need more computers in Canada than you ever expected. And it certainly made it harder for the small branch with a runoff of leftover business to be cost-justified.

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The economic and regulatory environment in Canada is such that most Canadian insurers are federally regulated, which is generally good news. We don't get into these cross-state regulatory issues that I hear occupy a lot of people's time in the U.S. That would be where one state allows something but another state doesn't. Basically, once you persuade OSFI that you're solid or not, that's the end of it.

A second large segment of the industry is provincially regulated in the Province of Quebec. This segment tends to be the dominant institutions inside the Province of Quebec, although they are allowed to operate outside Quebec. The way the Quebec companies have been operating – and it's partly legal happenstance – is that they seemed to acquire federal companies to do their business outside Quebec. That's certainly not a regulatory requirement. It's more of a fact of history that they were in an acquisition mode at various times in the past.

We have had the first major insurance insolvencies in Canada in the last two years. We used to proudly boast that no insurance policyholder had ever lost money because of an insolvency. It's still true that no policyholder has lost money, but we've had a couple of big failures in CompCorp, the industry solvency fund. Insurance departments had to step in, which had been interesting for everybody. CompCorp is an industry funded vehicle. Hence there have been assessments on the rest of the industry because of the insolvencies of a couple of companies.

One of the insolvencies was a Quebec-based company operating prior to these new rules on actuaries. The jury is still out on whether the rules would or would not have made a difference. I have no first-hand knowledge to say whether it would have or not.

We've also had several bank and trust company failures in recent years. Again, there were big headlines. My gosh, that was supposed to be impossible. We've had a couple of near failures where various companies were certainly close to the brink and managed to negotiate for themselves new, strong and healthy owners. So, again, no one lost money. But it made people a little more cautious about where they put their money.

So, the upshot of all this is that everyone including the regulators, the auditors, the CompCorp solvency fund, and the deposit insurance corporation for banks is looking for any avenue to enforce and encourage solvency, and as you will hear in the rest of this presentation, the appointed actuary in Canada is certainly central to that role. Certainly in a legal sense, the actuary is in the scapegoat position if something doesn't work out.

So, how does one do all this?

As I said, the new Act implemented something called Canadian GAAP, and like U.S. GAAP, you have to make an assumption for every relevant contingency: lapses, expenses, mortality, investments, defaults, anything that's relevant. And relevant is defined as, well, if in doubt, you have to think about it, at least show that maybe it doesn't matter. Unlike U.S. GAAP, the valuation premium is equal to the gross premium. This is in a sense a gross premium valuation, but your assumptions and your valuation basis are very different than your gross premium basis, one hopes. It also makes your reserves very sensitive to changes in the assumptions. One of the changes, or one of the requirements under GAAP, is that your valuation basis is supposed to be adjusted every year to reflect the emerging reality. So, if interest rates are up or down, or expenses are a little off, or whatever, you're supposed to strike a new valuation basis every year. Or, at least show that the trend wasn't enough to be a problem. But we're now in the first year-end where people are rethinking their valuation basis, and as I'm sure you can imagine, you have the potential to swing things by major amounts of dollars by saying, for example, mortality is 2% better than it was last year or not. And so that should be an interesting year-end.

Assets are valued on the moving to market basis as opposed to the old historical cost basis.

Coincident with implementation of GAAP and PPM, we have the new minimum continuing capital and surplus requirements, which are called MCCSR. And the way you can tell American from Canadian actuaries is that the Canadians can rattle off MCCSR without stumbling. In concept, it's very much like the U.S. risk-based capital requirements. There's an asset requirement, and it's a percent of assets. Good assets have a low percent, and poor assets have a high percent. There's a mortality requirement reflecting the net amount at risk, and it has a scaling factor for size. The larger companies have less statistical fluctuation and, therefore, a smaller MCCSR requirement for mortality. There's a mismatch factor that reflects the term of your liability, and it's not reflected in MCCSR, but we'll be discussing the various testing you have to do to satisfy yourself about the adequacy of your reserves.

In terms of how we implemented all that, well, we had to develop some new valuation systems, as did most of the industry. This wasn't too hard. As was done in the 1978 Canadian method, we had to make an assumption for every relevant contingency. Under PPM, some factors are more sensitive than others, and maybe we're a little more refined. But we certainly had most of the machinery in place. In our own case, we had to develop data feeds from our branch systems into our subsidiary valuation system. But again with the miracles of electronics and databases and so forth, this was relatively straightforward. We had to reconcile results. I won't call it problems, but it's certainly an extra step to have to reconcile more sets of data. In addition, we had the horror of multiple reporting bases, although we had this before. We now have U.S. GAAP at the branch. We have U.S. statutory. In Canada, tax reserves are on something called the one-and-a-half-year preliminary term method, and they aren't at all related to statutory reserves. You always have to explain the difference because people expect them to be the same. This is something else to reconcile. We also do an internal set of profit numbers, which are not statutory in either country. They're what we think would be a fair profit center representation of the business. The result of all of this is that we get more sets of numbers floating around. Every time numbers are different, we need more explanations about why they're different. We have to prove that the difference is correct. There's not much to prove except to say that, well, we did it this way. But you have to explain it all the time.

Previously, when the answers weren't too different, then we just simply mumbled that it was a different basis and no one asked closely. Now, we write (I'm not exaggerating!) a full page of the item-by-item discrepancies. And it's not just the reserves. Now you have accrual versus cash accounting. You have moving to market versus historic asset values. Almost every item on your balance sheet is now different, and therefore, you have to explain the difference between the two.

Finally, in Canada, the branch balance sheet did not historically have to be a balance sheet. You used to list your liabilities in Canada and you listed the assets, which you chose to designate, as being in Canada. As long as the assets exceeded the liability by the required margin, no one asked you to explain where the assets came from or how they moved from last year. The OSFI has stated in fairly strong terms that it can't regulate a branch if the branch is not at least reporting on the same basis as a Canadian company. Therefore, branches will be filing balance sheets in the near future.

Under Canadian GAAP or PPM, as I said earlier, the valuation premium equals the gross premium. So, your future profit is only the release of your valuation margins. Let's think about that for a minute. If you put in exactly your expected mortality and that's exactly what happened and there were no other factors, you would not have future profits on your in-force business. You would just release precisely the amount of reserve you needed to cover expected claims. But because you built in a valuation margin, you have a profit that's exactly equal to the amount by which your valuation mortality exceeded your actual mortality, and so on for every material contingency. The good news of this, or bad news, is that the present value of any additional profit is recognized or front-ended at the time of sale. So, if you have a big selling year and your prices are adequate, you report a big profit in the year of sale. And then if you later discover your reserves were not adequate or your prices were not adequate, you report losses every year. Except that if you have decided that your basis is not adequate, you have to strengthen your basis. And the day that you strengthen your basis, your reserves go up until you get to more or less break even. This is kind of unsettling for people used to a more leveled reporting approach. A few people's reaction, or the American parent's reaction is, "That can't be right." Well, it's certainly right, and it's certainly there by design. That was the intent. It was debated extensively when it was brought out. That's what was intended, and that's what it is doing.

There were concerns expressed about the potential of front-ending large amounts of profits, and this was deemed inherently unsound. You're reporting all these profits on premiums you haven't received yet. The good news or the bad news about that is that no one was charging enough to have any profits at the front end. So front-ending of profits was a nonissue.

There's a fair bit of debate right now on participating insurance, and here's the rub. In the concept, you pay out all your profits in dividends. You're operating on a temporary surplus philosophy. If, as required, you factored in your future dividends in your reserves, you would use up the valuation margins. Then there wouldn't be any surplus in the company, which is exactly the result you should get if this is the way your arithmetic is done. The result of this would be that, if some of these principles were strictly applied, half of the largest life insurers in Canada with total assets of $100 or $200 billion would be insolvent. That wasn't the intent, but that's what we would conclude if you strictly applied the technique paper. So, the profession is having a little debate about that. Paul may have some comments later.

Finally, as I said, with the front-ending of profits, you can and do get negative reserves. That is to say, if you didn't sell anything, your reserves would be $100 million this year. But because we sold some business, your reserves are only $90 million. That front-ending of profits is what you use to cover your additional high first-year expenses. And that's how you can show a profit in the year of sale despite high front-end expenses. Now, having said that, you have to identify the amount of your negative reserve and set aside surplus. You still have to have the surplus, but you can report a profit and move money directly from surplus.

I'm going to save my personal observations after Paul covers the rest of the Act. Then we'll both make some comments on how we think the Act is doing. For anyone who missed it, we have the President-Elect and the two Past Presidents and the current President of the Canadian Institute of Actuaries. So, if you really want to know how things are going in Canada, we can certainly have a good discussion for you.

MR. PAUL WINOKUR: First, I want to comment on one observation Steve made toward the end about Canadian GAAP reserves where you have to increase your statement reserves so that you break even. I think it's important to clarify that even under the new Canadian GAAP environment, by the time you put in a proper provision for adverse deviation, there are still situations where you're showing losses in the year of sale because of all the other requirements we have and valuation technique papers. So, I know that's not common, but it is happening.

The actuary is, in the case of a company, appointed by the board and in cases of a branch, appointed by either the board or the chief agent. OSFI has allowed the possibility in the cases of a branch, in order to avoid bothering the entire board of directors of a foreign company or the chief agent, himself or herself, to actually make the written designation of the appointed actuary. In practice, I think everyone prefers that it be a full board of directors resolution.

I'll concentrate on branches, although I'll try to indicate where there is commonality between companies and branches. The official reporting relationship of the actuary is with whomever is designated by the board of the foreign company, and often that will be the chief agent. In the past, prior to the Insurance Companies Act, the chief agent in many instances, particularly in smaller branches, did not have a very significant role. This is where branches were relatively inactive, and there were very few liabilities in Canada of the foreign company. But even somewhat prior to the new Act, OSFI tightened up under the role of the chief agent. For example, now the chief agent's signature must be on all the reinsurance treaties. That wasn't the case in the past. You often had someone who was doing the job part-time and would have great difficulty in good faith signing the reinsurance treaty because he or she wouldn't know many of the technical terms, for example. This particular person always had to sign the OSFI statement and have his or her signature notarized to the effect that everything there was true, accurate, and complete.

The actuary must technically be acceptable to OSFI. It's very rare, but OSFI, in theory, could veto the appointment of the appointed actuary. There are requirements, both under the Act and under the Canadian Institute of Actuaries standards of practice, which require any outgoing appointed actuary to communicate in writing with the board, or the chief agent in Canada in the case of a branch, as to the circumstances surrounding that actuary no longer being the appointed actuary. And I guess it should be obvious that is a protection of sorts to the actuary. Similarly, the incoming appointed actuary must communicate with the prior or outgoing appointed actuary just to insure that there are no professional reasons that the new actuary should not undertake the duties or the assignment. Again, that one technically doesn't have to be in writing, but OSFI does want to hear everyone's side of the story just to make sure there's nothing unusual going on.

It was interesting, at Session 5 of this meeting at which Mr. Callahan specifically said he did not like the concept of the actuary serving two different masters: one master being management or the president, and the other master being the regulator. But I think in practice what we have in Canada now is that we are, in effect, serving two masters. I'll have some specific comments to make on that.

The actuary has qualified privilege in certain matters, which some people refer to as the whistle-blowing duties of the Act, and it's qualified privilege from OSFI that the actuary was in fact acting in good faith.

I'm going to talk about professional conduct in terms of matters required by both the Act and by the CIA. We have more uniform rules of professional conduct in North America. As you know, we have a new rule, number 13, which we call the Self-Policing Rule, or some people call it the Snitch Rule. This is very similar to Society of Actuaries precept number 15. There are temporary exemptions from reporting members if you're in an adversarial situation. So this is temporary exemption until the adversarial situation is no longer there, or if the situation has not been rectified, then there is a duty to report the member or the student. I want to clarify that both members and students are subject to our rules of professional conduct. The failure to report a member is in itself a violation of the rule. In accordance with our agreement, any U.S. resident who is acting in Canada would be subject to the Canadian rules of professional conduct.

The CIA has what's called a compliance questionnaire which the actuary must complete each spring based on the prior year-end for purposes of confirming in writing that the actuary has compiled with all the relevant standards of practice for the appointed actuary function. That questionnaire is confidential between the member and the Institute. However, the Institute does reserve the right to report the member to the discipline committee if it is discovered that there was noncompliance. The questionnaire is not a public document, although some external auditors do ask for a copy of it. And I think, in most instances, the member will agree to provide it to the external auditor. OSFI has a slightly different, very short-form questionnaire, and we hope, over time, there will only be one questionnaire that everyone could agree on. The questionnaire itself does not currently talk about rules of professional conduct. It only discusses standards of practice. But it is possible that some day we will have a separate questionnaire or a portion of this questionnaire that will discuss compliance with rules of professional conduct.

Getting back to the standards of practice in terms of compliance, Steve indicated that for this year-end all branches will have to do proper Canadian GAAP and proper full Canadian financial reporting. However, the financial reporting committee of the Institute will, in special circumstances, or what they will call exceptional circumstances, allow exemptions for this. One word used in one memorandum from the financial reporting committee was for *tiny* branches. *Tiny* has not yet been publicly defined. I called the chairperson of the financial reporting committee last week, who indicated that he has already received two requests for exemptions, and in reading between the lines, it sounded like one was approved and one wasn't approved.

Now, even if a branch has an exemption, the actuary still must be satisfied that the reserves are adequate and appropriate. And, in order to do that, some testing and modeling would have to be done, and we are allowed to use approximations in so doing. Compliance questionnaires specifically discuss approximations, all subject to materiality constraints. Up until very recently, we had not had much guidance on what materiality means or how to deal with the problem of materiality, but very recently, we did receive the first draft of a guidance note on the materiality.

In some of the branches that I act for I will be using approximations to a significant extent to satisfy myself as to adequacy, but where I tend to do it more is on the front-ending of the profit issue. I want to be as precise as I can be for my best estimates and my reserves. I want to be as precise as I can be in my provisions for adverse deviation in my reserve and my assumptions. But then the question becomes, if there's anything left over, could I have or could I not have called it profit? And it's in that area where I'll use broader approximations if I know I'll be erring on the conservative side whether I have an exemption officially or not.

There are various types of reporting relationships. Branches are subject to all of these as are companies. The first one is that the CIA and the Canadian Institute of Chartered Accountants (CICA) have agreed on a joint policy statement, which defines in greater detail what the expected roles of the actuary and external auditor are. It does require an exchange of correspondence between the actuary and the auditor just to insure that they have come to agreement on who does what and what the reliances are. In the audited financial statements, there must also be a separate statement of the description of the role of the auditor and the role of the actuary.

The report of the appointed actuary is perhaps one of the most important documents produced. It is the one that accompanies the OSFI statement at year-end. It is the one that describes in great detail all the assumptions and methodologies used. It is not a public document. There is no standard format for this report. I've seen reports that are as short as three or four pages long for a branch. For branches, I've seen them as long as 60 or 70 pages. But clearly, there may be situations where a very short report can be justified.

OSFI issues an annual memorandum to appointed actuaries that includes the check list, which is similar to a questionnaire, that indicates the detail and content that OSFI would like to see in the report. It was mentioned by one of the people on the panel that some of the state regulators don't get back to the actuaries. They haven't necessarily. There's no evidence that they've read all the cash-flow reports or the adequacy reports. My experience with OSFI people has been that they are now reading all the reports of the appointed actuary. It seems clear to me that for the companies that they have on their watch list, they read those reports first, of course. But even as far as the companies that have very high surplus ratios and very satisfactory surplus positions, their reports get read as well. Those people may not get questions from OSFI until August or September of each year. July or August is more common. But the companies in trouble may hear from OSFI within three or four weeks of the report being received. I've also seen situations where for companies that are on the watch list, OSFI actually comes in before the statement is even finalized. I've seen OSFI go in there in early February to do what it calls a desk audit while, in fact, the company is trying to put its research together. I know that's exceptional, but it is being done.

Dynamic solvency testing (DST) or a discussion of what the future financial condition of the company or the branch will be is another very important requirement under the new Act. For branches, particularly branches that are not actively writing the business and branches that have very strong surplus positions, there are some legitimate shortcuts that can be used in doing this report. My own personal view of DST was initially not a very favorable one. I thought it was going overboard. With hindsight I think it has served a very good purpose. I think there are some companies that did very little business planning per se, and for these companies to have a starting point for a five-year business plan, which must now reflect both existing business and new business under various scenarios, I think that has been helpful.

It was mentioned that the American Council of Life Insurance (ACLI) did not support actuaries being involved in surplus solvency standards or discussions of surplus. In Canada, it seems, however, that the Canadian Life and Health Insurance Association (CLHIA) body has in the end been supportive of the role of the actuary in this area. Where I have a problem with this right now is on participating business. Steve indicated we do have to wait for final standards on participating business, and there are similar issues for how to handle participating business for DST purposes.

For the actuary's report when published financial statements are involved, the wording has evolved over the years. In the old days, in the statutory statement, the buzz words were *good and sufficient provision*. Between 1978-91 year-end, in the statutory statement, they still were *good and sufficient*. However, in audited financials, the actuary had to indicate that the reserves were *adequate and appropriate*. Yet in the statutory statement, they had to be *good and sufficient*. The new wording indicates in the published financials that the valuation is *appropriate* and that the financial statements fairly present the results. However, the OSFI statement still does use the *good and sufficient* phraseology, but it has been compromised to indicate that it's only good and sufficient if we add in to the reserves the minimum surplus requirement. And that wording, we hope, will be fine-tuned further to satisfy the concerns expressed by many actuaries.

So, the actuary's report -- we use the word *report* in a published financial -- is literally two very short paragraphs. However, if the actuary cannot issue a clean report or what I prefer to call a certificate, then we do have suggested wording for qualified reports. The actuaries report in published financials might change in 1995, which is the target date for stating something further. Beyond stating that the valuation is appropriate, the actuary will have to state that the financial condition of the company is satisfactory. And we will get further guidance from our Institute on helping us decide whether we can make such a clean unqualified statement.

Let's discuss the DST report for one more moment. It was indicated that the regulators want to read those reports. But there's an issue as to whether they can legally hold onto those reports, or whether they're legally entitled to have those reports. It's crystal clear in Canada that it's the regulator under the Act who can request a report on future financial conditions, and does request it right now for life companies, and will be requesting it for some P&C companies. And it's crystal clear that report can remain permanently in the hands of the regulator. It also seems clear that most external auditors are asking for those reports and getting them. But it otherwise is not a public document.

I think it's helpful just to briefly go over some of the wording. I'm sorry this is a bit wide. The relevant section numbers of the Act are for companies versus branches, but the basic report indicates – and this is wording that is required in the OSFI statement – that the valuation shall be in accordance with generally accepted actuarial practice and with such changes and any additional directions that may be made by the Superintendent. The right of the Superintendent to override the actuary's reserves has always been there. It's not new with this Act. If the Superintendent did not like the reserves of the appointed actuary or in the past of the valuation actuary, the Superintendent had the right to substitute his own reserves for those of the valuation actuary. That continues to be the case. And the words *generally accepted actuarial practice* means, for all practical purposes, whatever the CIA says they mean. However, it's the second paragraph that refers to future financial conditions. It's section 630 for the branches, and this is the report that must be filed with the chief agent. It says, the actuary shall meet at least once during each filing year in order to report in accordance with generally accepted actuarial practice on the financial position of the company and, where a direction may be made by the Superintendent, on the expected future financial condition of the company. The OSFI memorandum to appointed actuaries now says that everybody has to do the report on future financial conditions. And it means meeting with the chief agent face to face.

Regarding standards of practice for the appointed actuary and section 631 of the Insurance Companies Act, it's section 631 that gets into this whistle-blowing aspect that I referred to earlier. The CIA has a standard and I'm trying to blend the two issues. One is, what does the CIA do and what does the Insurance Companies Act require? Some of this is my own editorial. The first thing, of course, if an actuary sees a problem, I believe that the actuary has to try to get the problem fixed through normal channels or normal means, and, of course, avoid whistle-blowing in order to have a good relationship with everyone. But perhaps there has been no success in this regard, and the actuary has made reasonable efforts to have a problem fixed. The problem does not have to be simply reserves being strengthened. Suppose the actuary identifies a material adverse condition in the company, and the material adverse condition could be the company writing a great deal of new business without sufficient capital. Or the company could have sufficient capital, but it could be writing very unprofitable business in very large amounts. The actuary has a duty to write, in the case of a branch, to the chief agent and express the concerns. And the actuary should provide or must provide a deadline for corrective action to be taken. At that time, that letter must be copied to the directors as well. That's a literal requirement the way I read it. I'll be pleased to be corrected later if I'm wrong on that. If no rectification has been made by the deadline, then the actuary has the duty to write to OSFI forthwith, and I believe the word *forthwith* is in the Act and in our standards.

Now, external auditors have similar duties, but they don't have the luxury of the extra step that the actuary does. The external auditor must go directly to OSFI simultaneously with the chief agent, and I'd love to hear some explanation later from someone in the audience as to the rationale for that missing step for the external auditor. Now, what's happened in practice? I know of two or three situations personally – one in the case of a company, which is a different section number, Section 365, and one or two in the cases of branches – where something has happened. In the case of one company I know of, it was a very simple matter that arose from a DST the actuary had done. The actuary had concluded that the company needed more capital. The president wasn't listening. The president didn't take this concern seriously. This was in 1992. And finally, the actuary felt compelled to write a very strong letter to his president saying, I need more capital and I need it very soon or else we have some problems, and there's a section of the Act that we're going to have to contend with. So, finally, just the mere act of the in-house actuary writing a strong letter to the president impaired the relationship between the two. And that's a reality.

In the case of a branch, I know of one branch situation where the actuary had some concerns. I don't know all the facts, but I believe it was similar. Concerns were expressed that weren't taken seriously. In this case, the actuary went all the way and had to write to OSFI. The actuary had to write to the chief agent and, in effect, wrote to the board of directors of the whole shooting match. This is a small branch of a large company. But the actuary felt compelled to write to the chief agent and the board of directors, and the situation, I believe, was rectified in the end.

In both of these instances, I believe the money was available. It was just, I think, a question of the actuary's word not being taken seriously. And it was the first year under the new Act. So, I think it is a difficult time to be an appointed actuary because of the economic conditions and because of the potential need for reserve strengthening, and there is going to be a learning curve, and there will be personal problems between actuaries and their presidents in trying to do the right thing.

There are other reporting requirements that, I believe, in almost every instance only affect companies. They do not affect branches at this time. And that is, for your information, there has to be an adoption of dividend policy and in some instances it's not the appointed actuary, but it's the dividend actuary who has to approve the document. He or she may or may not be the appointed actuary. The actuary must opine on both the monetary impact and adherence to the dividend policy. There's a similar policy regarding allocation of expenses, taxes, and investment income between participating and nonparticipating lines. The actuary must opine on both the policy and the monitoring of that policy. And the actuary must opine on shareholder transfers.

In the case of both branches and companies, there must be a statement of investment policy. Technically, to the best of my knowledge, the investment policy does not have to be approved by the appointed actuary. Practically, I would hope, the actuary would have input. And, of course, there must be a statement of how the company conducts its asset/liability management. I've had a recent case where, even though my report did refer to asset/liability management in the case of a branch, OSFI still wrote to the chief agent, rather than myself, asking more about the asset/liability management process. I found it interesting that OSFI put the onus in this instance on the chief agent to respond and to perhaps to become more knowledgeable in the area.

I'll just give you a few more issues that Steve asked me to talk about. This is the issue of the consultant versus the in-house actuary. I think it's a relevant question for both companies and branches. There are often concerns expressed that a consultant has more difficulty being knowledgeable about a company on a continuous basis, and that can be true. My own personal requirement before taking on an assignment as the appointed actuary of a branch is that I want to see quarterly financial statements. That's my own requirement. I like to see at least a balance sheet quarterly even though some of the liabilities may be kind of approximated for the first and second quarters. I don't want to see the company or the branch being caught off guard. I don't want any big surprises. Even though it's not my fault that they haven't found enough assets and turned it up, I just don't like signing statements of technically insolvent branches, although I have done it.

So, now let's discuss the continuous rule. I use the word quarterly. Now, I will not insist on a quarterly financial statement if I know a branch had a MCCSR that was extremely high, and some of the branches do have very high MCCSR positions. My own view is that it is possible for a consultant to serve as the appointed actuary effectively. I think one of the disadvantages is sometimes we hear about decisions a bit late. In the end, once the rules are established, I think it can work. I think the consultant's pocket has more leverage in exerting pressure on the company because, in theory, it's not his or her only source of livelihood if he or she has to take a stand. I know that's not fair. Many of the actuaries I know are taking very strong stands against management as well. I know of two in-house appointed actuaries, under the old Act, who resigned from their positions on matters of policy and principle, the differences of opinion of their companies. And this was even before the requirements of the new Act. So, I know there are both in-house actuaries and consulting actuaries who are doing very effective jobs.

I won't spend time talking about access to records outside Canada. Steve did discuss it. But my only concern there is this data quality where, again, for some smaller branches, the parent gives the least attention to the Canadian branch because it's often only 1 or 2% of the parent's total business. And here, I think, the certifying actuary has a duty to at least insure that the data are reliable. The auditors are doing more work on branches effective 1992-93, and even the appointed actuary for the branch will be able to use the work of the auditor in this area.

The other interesting issue is the solvency of the branch versus the solvency of the total company. Even though my branch may have a very high MCCSR and even though the assets may be held in trust, which OSFI could seize if it had to, that helps me a great deal. But it doesn't give me total assurance because, if the total company got into financial difficulty, it could still affect me and my branch. For example, my branch may have a very high retention limit based on the strength of the worldwide company even though it may not have enough surplus in Canada to justify a retention on its own of $500,000 or a million dollars or more. I have to be careful there. I could be caught off guard at year-end with one or two or three very large death claims, and then have a problem.

So, it's a real challenge. I think what I recommend is, in doing a DST report for a branch, it's essential to also comment on the solvency of the company as a whole and the strength of the company as a whole. But it's not feasible to do solvency testing for the whole company in the immediate context.

Unlicensed reinsurance is an area where OSFI has become much tougher, starting about three years ago. This has nothing to do with the Act. On unlicensed reinsurance, OSFI has said in writing that it believes that there's enough capacity in the licensed professional reinsurance market in Canada to prefer Canadian companies and branches not deal with unlicensed reinsurance if at all possible under any circumstances. It has reached the point where OSFI is now saying, unless you have some grandfather treaties out there, OSFI will not allow you to take a reserve credit in your statement unless it's reinsurance. OSFI always has allowed surplus appropriations for reserve credits on unlicensed reinsurance, but now OSFI is going much further. And there's a double-whammy effect here. It's not just the inability to take the reserve credit, which can blow your income statement out of the water, but also it's your MCCSR calculation, where in the mortality risk component part of the formula, you'll not be allowed to take credit for any unlicensed reinsurance in that part of the formula. Whether it's individual life, or nonparticipating guaranteed premium business, you're talking about a hit to your MCCSR of $2.50 per thousand on the risk you otherwise wanted to take credit for. It's a very serious problem that the actuary should, we hope, be on top of and not have any unpleasant surprises at year-end when doing the MCCSRs in particular.

Market-value fluctuations on the asset side have been a problem. I hope that the problem will be cleaned up with the new OSFI statements coming out for branches this year-end. In the old days, a branch could get caught off guard where you had to effectively use the lower of book or market value of your assets in a branch. And that also has some anomalies, both favorable and unfavorable in the MCCSR.

Currency fluctuations are not usually a serious problem for a branch, but they can be.

One other area is that many companies feel that their U.S. statutory reserves are, by definition, conservative. Why is it, therefore, not appropriate to continue to use U.S. statutory reserves as the Canadian reserves that they are known as conservative? As we indicated earlier, that's no longer acceptable. In particular, there are cases where even the U.S. statutory reserves are not conservative. You may have small average size policies where, if you allocated proper unit costs of administration to your Canadian branch and put in realistic assumptions for lapse and mortality and interest with provision for adverse deviation, you might find that the U.S. statutory reserves are, in fact, too low.

Similarly, there's U.S. reinsurance treaties where, under U.S. statutory, you don't have to reserve for full coinsurance allowances. You may be paying if you are a reinsurer, but you can be very generous and if you had reserved properly for the allowances, your reserves, in fact, would be significantly higher.

MR. PRINCE: I'm going to make a couple of personal observations and then draw a few parallels or contrasts to U.S. situations.

The first one is that this Act is certainly more work for actuaries and no one is disputing that. In our own company case, we seem to be coping with the existing actuarial staff.

The Act is making life more difficult for small companies, and as Paul said, some of the "obviously" solvent and well-reserved branches are perhaps not as adequate as they had thought. On a related point, it may be that your company is adequate and sound and conservatively reserved, but you can't afford your expected future dividend payments. In Canadian reserves, where you explicitly factor in your dividend scale and your future interest earnings, the reserves might tell you in a real hurry that you can't afford your dividends. That's probably a good thing to know well ahead of time.

In our own company's case, certainly the parent is committed to comply with the Act. The people there don't always understand it, but they're fully supportive. The actuary's report that I gave to our company went not only to our chief agent, but also to the management committee of the parent company, which includes the president, the chairperson and three or four internal board members. So, it certainly got listened to. Much of all of this testing is really just good management: As Paul said, the required scenario testing, the DST and the forward looking. Why would you not want to do that? The counter-argument would be, well, it's a lot of work. If you can't show that you're going to remain solvent in the future because it's too much work, someone's putting his or her priority in the wrong place.

In terms of explaining this to other people, this Act is more internally consistent and logical than the old system, which had evolved piecemeal over the years. You can explain PPM to people from square one. I recently taught a course on PPM reserves to an accounting professional meeting, and the accountants expected to be mystified. When you just walk through it step by step without all the artificialities introduced by the other methods, they sit there in disbelief. Well, this makes so much sense that one wonders why anyone was confused in the first place.

On the whole, I think that these changes required by the Act are positive developments, which is good because they are certainly required whether one likes it or not.

Let me contrast this with the U.S. I don't practice in the U.S., so these comments are really observations on what I heard. First, this is true solvency testing, not just cash-flow testing. Part of the solvency testing includes asset/liability matching in cash-flow testing. We have required scenarios like worsening expenses or worsening lapses, or improving sales, or declining sales, and so on. And these things are just simply prudent things that you want to do.

Additional reserves are at the discretion of the actuary, although the Superintendent's office can override that. The emphasis here is on being correct, not on simply complying with the rules. In Bob Dreyer's comments in Session 5, he compared a company to a plane that was off course. He took what he thought was a justifiable plan to correct this but was not entitled to reserve relief for it. The situation in Canada is different. Suppose you realize you have gone off course, and you figured out why you were off course. You're now on a new course, which will get you to the correct target, and you have enough gas in the tank. I know I don't need to stop off for more gas, or, in other words, I don't have to set up additional reserves. Equally though, if you're on course, but there's a storm coming, it's not enough to say, well, we're on course. You have to look ahead and do the prudent thing. And as we said, OSFI can always tell you that it wants you to do more anyway.

There's the significant reliance on the profession through the Canadian Institute of Actuaries to define standards of practice, which are binding on people, also guidance notes, which are nonbinding, on how things are to be done. What is GAAP? It's a due process for development and adoption of standards. There are multiple committees working on these types of things. As I said earlier, I'm Chairperson of the Life Practice Committee. There is also a committee on the life insurance financial reporting, a committee on P&C financial reporting, a committee on solvency testing and a committee on asset/liability matching. All of these committees put out papers in what are initial discussion drafts, and then an exposure draft as to what one expects will become the requirement, followed by a final exposure draft.

As far as due process, we have ample input from the profession at large and ample discussion. In some cases, these steps can take a couple of years to work through the mill. But the end result is something that the profession certainly believes in, which is justifiable from actuarial principles, and which then becomes binding.

And finally, as I said, the regulatory environment in Canada is that most companies are regulated federally. So, we don't have these concerns on inconsistencies or lack of harmony between regulations.

MR. MORRIS W. CHAMBERS: I have a response to Paul. I'll be interested in whether Paul's colleague agrees with me. Paul had questioned why it might be that the auditor of the company is not in a situation of serious financial conflict. It is not required, first, or not expected, first, to discuss the matter with management and see if rectification cannot be a first step. Rather the auditing people are required, at the same time, as they contact the company and management, to inform OSFI. My own expectation is that the auditor does not have day-to-day on-hand contact with the company. In fact, the auditor, in most instances, is only in the company once a year in dealing with the financial statements that are about to be published. And my expectation is that in that situation where he or she uncovers something that is of a serious financial nature, that there simply is no time on the part of OSFI's expectation to seek rectification, and that it must be dealt with immediately. There's no opportunity to sit around and wait and see if management does something about it.

MR. JAMES A. BRIERLEY: I have two points. One is I'd just like to expand a bit on Mo's response to Paul. I think some of the thinking behind the lack of the ability of the auditor to go to management without OSFI is just a matter of probabilities. There's just less likelihood that an auditor is going to be finding a problem that can be corrected before it goes off the rails. The auditor's view of the enterprise is more short term, and also retrospective whereas the actuary's view, we hope, is a little longer term as he or she is concentrating on a future contingent events and, therefore, more likely to find something that might be correctable without regulatory intervention.

My other point or question is to Paul. On those cases where the MCCSR ratio is quite large in a branch, you feel more comfortable with not checking in on the branch as often. But because it is a branch, do you not have any concerns that those funds could be pulled out of Canada any time, and there's no requirement to deposit those assets in the trust funds? They could be removed, and I'm aware of cases where they have been. Do you have any thoughts on what a consulting actuary can do to keep current on that type of a situation?

MR. WINOKUR: Yes. I'd like to respond. I have worked with auditors a great deal, and I have noticed in the last few years with the professional liability problems that they have been having, that they are taking a very hands-on approach. Many of them come in at third-quarter-end to do a preliminary review. They do receive copies of unaudited financial statements quarterly in many instances. And I think there are circumstances arising during the course of the year. I agree. If they find a problem on January 15 and they have to sign off on January 16, there's not a lot of time to react. But I think there are times in the last quarter of the year where an auditor could still have an important discussion with management and could try to help rectify situations without having to go to OSFI directly. So, and I know in practice, it happens. It's just a matter of form, I think, here.

I think in practice the auditors do have good chats with management before going to OSFI. I know the external auditors are now asking for copies of the MCCSRs before they sign off. A lot, as you know, can go wrong during the year, and they're very worried.

On the issue of the MCCSR, I agree. I don't like to go 10 months or 11 months without speaking to the branch or to the chief agent. In some instances, they'll just send me copies of the trust account monthly. I like to see what's in the trust account monthly in terms of assets, and I can guess at the liabilities. I understand there may be circumstances where they could remove money from Canada without telling the actuary and that is a concern. Sometimes I'll just have a chat with my contact, who may or may not be the chief agent. Say, anything new? To the best of your knowledge, has anyone taken money out? And I agree. It is a concern. Even if there is a high MCCSR, I know the wording of the trust accounts vary from case to case, and there are assets under the control of chief agents that could be removed without telling me as well.

MR. CHAMBERS: I may have misled you. I'm not saying that the auditor should not be dealt with the same way in the Act as is the actuary. I expect that the thinking of the drafters at the legislation was of the nature that I described. There are other areas in the Act where I think the drafters of the legislation were on the wrong track as well.