

MCT + IFRS

More than the sum of its parts

In the post-Enron/post-Lehman world, the framework within which financial institutions and insurance companies (including LAWPRO) operate is increasingly regulated and prescribed – perhaps more so than in most industries. Knowing, understanding and complying with this steady stream of consultation, regulation and compliance regimes of course creates extra work, requires additional infrastructure (at a cost) and presents bottom-line challenges that were not even on the radar a few years ago.

We've discussed this new world order in previous Insurance Biz columns in which we explained two acronyms that are on everyone's tongues (at least in the insurance industry) these days: The Minimum Capital Test (MCT),¹ a benchmark requirement of our regulator, and International Financial Reporting Standards (IFRS).²

In those articles, we explained the need for LAWPRO to meet prescribed financial solvency tests (via the MCT calculation) and

the likely impact that a new financial reporting regime (IFRS) being adopted worldwide will have on the insurance industry.

What's become clear over the past year is that the inter-relationship between IFRS and MCT may well have even more impact than originally expected.

First the MCT – probably the single most important test that Canadian regulators use to assess the capital adequacy of an insurer such as LAWPRO.

As described in our earlier article on this subject, the MCT is a ratio calculation that compares the capital available (our net assets) to the capital we need to meet our financial obligations – i.e., claims costs. Our regulator, the Financial Services Commission of Ontario, has stringent requirements that apply to both sides of the MCT equation.

(These in turn are based on requirements of the national regulator for the financial services industry, the Office of the Superintendent of Financial Institutions – OSFI). For example, the MCT calculation must include prescribed additional capital or margins that vary depending on the assets and liabilities on the insurer’s balance sheet.

At mid year, LAWPRO’s MCT stood at 220 per cent – below the 260+ per cent average of all Canadian insurers. But the LAWPRO Board believes that an MCT of between 220 and 230 per cent is appropriate as it allows us the room to weather unexpected losses or poorer-than-expected investment returns and still ensure the regulator that we are stable and secure. LAWPRO’s ability to set premiums and raise capital – which is different from many other insurers which often must rely on fickle capital markets – makes a lower than average MCT feasible and reasonable.

To maintain an MCT in the desired range, we need to make a profit of about \$5 million a year. With the premium increases of 2010 and 2011 we achieved that goal while also ensuring we have the funds to pay claims which now hover in the \$80-\$90 million mark per year of operating the primary professional liability program.

But changes are coming to the way in which the MCT ratio is calculated. According to OSFI’s own published modelling, that change is expected to see insurers’ MCT drop an average of 14 per cent – **without the insurer having made any change in its underlying operations.**

It will take a concerted effort on the cost side – that is on the capital required side of the MCT equation – to ensure LAWPRO continues to maintain an MCT result in the 220 to 230 per cent range.

IFRS – a complicating factor

Compounding this situation are the known and unknown changes coming via IFRS.

You’ll start to see the first impact of these changes this year: Financial statements for

2011 must be IFRS compliant – meaning we will see a new form of balance sheet and significantly more information in the Notes section of our annual report, to be released in April 2012.

Of particular interest to LAWPRO are how investments are going to be treated under IFRS and the impact that IFRS could have on the fundamental concepts used in insurance company accounting – especially the costing of claims which may undergo a profound change that sees us revert to a previous model.

First – the issue of investments.

A few years ago, the financial reporting world moved to a fair-value accounting model which introduced the concept of comprehensive income.

This allowed companies to account for unrealized gains and losses in their investment portfolios through the comprehensive income portion of their financial statements and separate them from the bottom line. LAWPRO took this option for its surplus investment portfolio – that is, for those investments that are surplus to the capital needed to fund our claim portfolio (these investments are referred to as our matched portfolio). For the latter, LAWPRO opted to have gains (or losses) in the matched portfolio flow through our income statement – that is, show up on the bottom line.

Proposed IFRS rules that will come into effect in the next two to four years may see us partially revert to the pre-2007 days.

If implemented as drafted, new IFRS rules would greatly diminish the use of other comprehensive income; in fact, in our case, the OCI line on our financial statements could disappear. That’s because the proposed changes would see unrealized gains in our surplus portfolio removed from the other comprehensive income line, and the unrealized gains/losses on the bond portion of the surplus portfolio drop off LAWPRO’s balance sheet entirely (until that investment is actually sold).

The impact of this proposition is two-fold: Shareholders’ equity (the value of the investment that the bar has in LAWPRO) would diminish. And – unless our regulator makes subsequent modifications to the way in which MCT is to be calculated – our MCT would fall. For example, if we applied the new rules to our June 30 financial results, we’d take a four per cent haircut off the MCT. So IFRS could create a new source of pressure when it comes to meeting our regulator’s solvency tests.

Another source of concern is IFRS 4 – Phase 2, expected to come into effect in 2014-2015. Of specific concern to us is a possible change in the treatment of the time value of money (the discount rate).

The discount rate is the assumed future interest rate that we use to determine how much money we need TODAY to pay claims in the FUTURE. There’s talk in accounting circles of implementing a **risk-free** discount rate.

What that means we’re not quite sure. Does it mean the bank rate set by the Bank of Canada or federal government bond yields? Will it have a two-year or 30-year horizon? We won’t know those details for a while yet.

But one thing we do know: Its impact can only be unfavourable. For example, a 50 basis point drop in the discount rate results in a \$5 million hit to the LAWPRO bottom line. So rethinking the discount rate affects not only our bottom line – in that we have to raise reserves – but also our MCT in that it increases the capital required side of the MCT equation. And for LAWPRO, the major way to increase capital is through premium revenue.

No matter how we look at it, maintaining a healthy insurance company in this new world is going to be our focus in the foreseeable future. ■

¹ “Why profit is not always a bad word”: *LAWPRO Magazine* September 2010 Vol. 9 no 2; pages 14-15; <http://www.google.com/url?q=http://www.practicepro.ca/LAWPROMag/InsuranceBizProfit>

² “Gearing up for IFRS at LAWPRO”: *LAWPRO Magazine* December 2010 Vol. 9 no. 4; page 13; http://www.google.com/url?q=http://www.practicepro.ca/LAWPROMag/IFRS_LAWPRO