Navigating a brave new world: Prudential regulation and Canada's life insurance industry

**Remarks by Jeremy Rudin,
Superintendent of Financial Institutions**

**Life Insurance Invitational Forum
Cambridge, Ontario
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The theme for this conference is: confronting a brave new world. This is a reference, I am sure, to the changes that have affected the life insurance industry since the global financial crisis. While many think of that crisis as a banking crisis, the implications for the life insurance industry have also been far-reaching. Why?

One reason is that we all have a better appreciation for just how volatile asset values can be and how difficult they are to predict. Before the crisis, we all looked at the very long horizons of life insurance liabilities to take comfort in using long-term historical averages of asset returns as predictors. Our new appreciation of the potential fragility of this approach has had a profound impact on how regulators and companies look at the risks facing the life insurance industry.

Another reason for the impact of the global financial crisis on insurance regulation, of course, is AIG. While it was not AIG's traditional insurance activities that led it to the brink of failure, AIG used its position as a highly rated insurance company as its entrée into much riskier businesses.

The third reason is that the financial crisis reinforced the notion that the financial services industry and the public are partners. This partnership arises because the efficient and uninterrupted provision of financial services is essential to economic growth. When that is threatened, the public (through its government) is likely to feel compelled to intervene to support the industry. As a result, the public has strong reasons to seek to prevent any such disruption.

This applies to insurance services as well as to banking. We can see this in the reaction to insurance company failures in Canada and other countries. Insurance company failures often lead to stronger regulation in a way that failures outside of the financial services industry do not.

In Canada, the Office of the Superintendent of Insurance was established in the late 1800s in response to problems experienced in the industry. The Office of the Inspector General of Banks was not established until 1925, after the failure of Home Bank. As late as 1974, the total staff complement of the Inspector General was only four people while the Office of the Superintendent of Insurance was considerably larger.

Fortunately, Canada has not experienced a major life insurance failure for 20 years. But we all know that concerns about the viability of Confederation Life forced the government and the industry to intervene.

Looking abroad, we see that the failure of HIH Insurance in Australia 13 years ago still casts a long shadow over Australia's financial sector and its reputation. Losses were over $5 billion. Regulation and supervision of insurance companies in Australia intensified as a result.

So, how are we going to navigate this brave new world? For OSFI, I see four compass points that will help us chart our way:

1. First, responsible risk management;
2. Second, consultation: with you as well as with other regulators;
3. Third: standards in regulation and supervision, internationally and domestically; and
4. Fourth, flexibility in adapting global rules to the Canadian reality.

Risk management

Let's start with the "true north" of our regulatory framework: responsible risk management by Canada's financial institutions, including insurance companies.

In this context, the term "responsible risk management" carries a double meaning. First, at OSFI we like to emphasize that it is the boards and management of financial institutions, and only they, who are responsible for taking risks and for managing risks. At the same time, our regulation and supervision is aimed at ensuring that risk taking remains responsible rather than excessive. And the yardstick that we use to determine the dividing line between "responsible" and "excessive" is the public interest.

To achieve this balance between the roles of insurers and OSFI:

1. First, we set expectations for financial institutions, in other words, we issue guidance; and
2. Second, we monitor closely how individual financial institutions adhere to that guidance, in other words, our supervisory work.

One of the things that we expect is that your boards and management will have a very thorough understanding of the interrelationships between your company's risk profiles and future capital needs.

A very relevant, and quite recent example is our guidance about Own Risk and Solvency Assessments, or ORSA. We at OSFI, like other prudential regulators of insurers around the world, have raised our expectations about insurers' own assessments of their risks and capital needs.

I should emphasize that in the phrase “Own Risk and Solvency Assessment” the word “Own” modifies “Assessment”. (I will admit that this wasn’t clear to me the first time I heard this phrase.) We expect each institution’s ORSA to reflect the board’s and management’s assessment of the risks, not our assessment, and not the external auditor’s assessment. As such, each insurance company is required by OSFI to present its ORSA to its board or chief agent every year.

An ORSA is a forward-looking process consistent with an insurance firm’s strategic and business plans. It explores and assesses potential threats to capital and solvency positions. Your ORSA will provide senior management’s view on risk assessment, risk management and planning to your board or chief agent.

In Guideline E-19 issued in January this year, OSFI outlined its expectations with regard to an insurer’s ORSA. ORSAs are relatively new in Canada. But most components of the ORSA process – such as dynamic capital adequacy testing, sound governance and risk management – should be familiar to Canadian insurers.

We have asked to see the ORSAs as they are approved. One reason is so that we can compile a list of “best practices” for the industry as a whole.

So far, OSFI has received a handful of ORSAs, mostly from smaller, less-complex life insurers. Some insurers already had sophisticated perspectives based on their own, solid risk-assessment practices. Others have made do with a feed-in to their parent company’s ORSA.

Finally, there is a group (hopefully, very small) that is still coming to grips with the ORSA process. Some companies find the emerging-risk piece is a struggle. Thinking about “unknown unknowns” is hard, by definition.

Company management can start by asking that very good question, “What keeps us awake at night?” This can be formalized into a robust emerging-risk process.

In the same vein, a company’s board should question that process until it evolves to the point of helping the directors to sleep at night.

Consultation

The second compass point, consultation, is at the foundation of our work. In my first few months as Superintendent, I have devoted considerable time to meeting with, and listening to leaders across the financial sector, including the insurance industry.

These conversations have been very helpful in allowing me to understand your issues and perspectives. I know that regular consultation with you is baked into OSFI’s regulatory and supervisory processes, as it should be.

You will recall that OSFI had extensive discussions with key stakeholders in the industry to develop the Life Insurance Regulatory Framework, released in 2012.

I am happy to report that the implementation of the framework – or “road map”, as we call it – is on track. The recent Quantitative Impact Studies have shed light on where it is advisable to calibrate changes to the Minimum Continuing Capital and Surplus Requirements – the MCCSR. In 2015, we anticipate more definitive consultation with industry on further changes to the MCCSR; these are planned for implementation in 2018.

We are also consulting with you in the international arena. We have a Canadian, Frank Swedlove of the CLHIA, who recently completed his term as inaugural chair of the Global Federation of Insurance Associations. The federation is deeply engaged with the International Association of Insurance Supervisors – the IAIS, of which OSFI is a member.

OSFI has been promoting reforms in the organization. We are happy to see the IAIS adopting the practices and governance structure of other bodies that support the Financial Stability Board. The IAIS is improving its planning, organizational efficiency, focus, and governance. It is developing a formal, robust and transparent process to streamline stakeholder consultations. Given the extremely important assignments the IAIS has undertaken for the FSB, this is good news.

As part of these reforms, the Observer category at the IAIS is being eliminated. I know that some insurers are concerned that this reform will reduce transparency at the IAIS.

I certainly agree that the IAIS needs to keep a window open for the industry to contribute to its deliberations. I am very supportive of the new IAIS consultative mechanism. It is similar to OSFI’s own approach to consultations, so I am confident it will be satisfactory.

Given this new consultative approach, I support the elimination of the Observer category. My view is that closed-door deliberations are an important part of international co-operation and standard setting among regulators. Based on my experience in other areas of international financial system issues, it is hard to see how the IAIS has managed without having this option.

Standards

Let’s move to the third compass point that guides our direction – the evolving domestic and international standards for each pillar of the financial sector.

OSFI continues to work with the IAIS in establishing international standards, particularly where this engagement is of clear benefit to Canada. The IAIS has become very successful in bringing jurisdictions together to achieve consensus.

One of the first post-crisis tasks given to the IAIS by the Financial Stability Board was to identify global systemically important insurers, or G-SIIs. As you know, there are no Canadian insurers on the 2014 list of G-SIIs.

A second task was to set international minimum standards that would apply to G-SIIs: the Basic Capital Requirement (BCR) and the associated Higher Loss Absorbency requirement. The IAIS has published two consultation papers on the BCR to date.

As we have no companies on the G-SII list, the IAIS Basic Capital Requirement and the Higher Loss Absorbency requirement will not directly apply to any Canadian companies, as it stands now.

In the longer term, the IAIS will develop group-wide insurance capital standards for internationally active insurers, much like the Basel Committee on Banking Supervision has done for internationally active banks.

I am sometimes asked whether we even need an international capital standard for the insurance sector. I certainly think it would be an important step forward. In particular, it will allow us at OSFI to benchmark much more easily our approach against what others are doing internationally.

Assuming that this capital standard garners widespread support among regulators worldwide, we expect to apply it to all federally regulated insurers that are internationally active. Just as we do with banks, we would carefully calibrate any international standard to fit the Canadian situation. I will elaborate on this in a few minutes when I discuss the fourth compass point: flexibility in Canadian regulation.

On the domestic front, I welcome recent developments at the Canadian Actuarial Standards Board. I am speaking about their new actuarial standards to address one of our shared concerns: the impact of prolonged low-interest rates on your investments and your long-term guarantees to policyholders.

Through the Board's revised standards for life insurer valuations, the impact of low-interest rates on your business will be more transparent. This is all to the good. OSFI will continue to monitor the implementation of these standards by life insurers.

Flexibility in Canadian regulation

And so we come to our fourth compass point: flexibility in fixing Canada's regulatory position.

International agreements on minimum norms are the best way for us to be able to impose prudent standards on our globally active financial institutions, without impeding their ability to compete with foreign institutions. That alone is a strong argument in favour of adhering to these agreements, and being seen to do so.

That said, OSFI looks carefully at the Canadian situation and Canadian needs before deciding how, and how closely, to adhere to each international standard.

At times, we have chosen to impose standards above the international minimums. In principle, this can put our internationally active institutions at something of a competitive disadvantage.

That can be the unintended, yet justifiable consequence of doing what is necessary to protect financial stability in Canada.

For example, the decision of my OSFI predecessors to go well beyond the Basel I and II capital requirements for banks helped Canada to come through the global crisis relatively unharmed.

If we at OSFI think that the eventual international capital standard for insurance companies is too low for Canadian purposes, we will set a higher bar. My successors may have cause to thank me for doing so, just as I am grateful to my predecessors who set a higher bar for banks.

On the other hand, when we judge that there is little or no value in exceeding an international minimum, we stay quite close to our agreements with global counterparts. Sometimes, that means bucking the trend, as with our decisions on preferred share issues and leverage limits for banks.

I would like to touch on one issue in particular where flexibility may be in order. As you know, the insurance contracts project of the International Accounting Standards Board (IASB) will have a significant impact on the industry.

The IASB has been listening to representations from industry and the regulatory community. We expect the IASB to issue their final guidance sometime in 2015.

We are all keenly aware that the proposed standards will impact the financial reporting of long-term insurance businesses, such as Canadian life insurance products.

Our first choice is always to closely align the regulatory capital requirement valuation basis with financial reporting. This reduces the compliance burden and makes it easier for counterparties and analysts to understand these often-complicated calculations.

That said, the most important consideration is that the capital requirements have to work as intended. So if we judge that maintaining a tight link between the accounting rules and the regulatory capital framework valuation basis would lead to too much volatility in the capital requirements, we will adjust the capital rules accordingly. You will find a more detailed explanation of this approach in the "road map" document from 2012.

Conclusion

To conclude, OSFI, the financial industry and global regulators have travelled a long and sometimes foggy road together since the financial crisis.

We all know that Canada weathered the global financial crisis relatively well. I believe that this is in great part due to the prudent management of our financial institutions.

I think that the actions of my skilled and dedicated colleagues at OSFI also played an important part.

Looking ahead, we will continue to navigate by relying on the four compass points I outlined today:

1. responsible risk management,
2. consultation,
3. domestic and international standards, and
4. flexibility.

Thank you.