



Office of the Superintendent of
Financial Institutions Canada

Bureau du surintendant des
institutions financières Canada

Report on

**Office of the Superintendent of
Financial Institutions**

**Regulation Sector
Actuarial Division – Supervision
Support**

Life Insurance Review

June 16, 2008



OSFI
BSIF

Canada

OSFI Regulation Sector – Actuarial Division Life Insurance Review

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1. Review Objective and Background

Regulation Sector – Actuarial Division – Supervisory Support

1.1 The objective of this review is to assess the Office of Superintendent and Financial Institutions (OSFI) Regulation Sector Actuarial Division's process and practices, including management oversight, for supporting the Supervision Sector – Financial Conglomerate Group Life Insurance (FCG -Life) and the Financial Institution Group – Life Insurance (FIG-Life) in Toronto, Montreal and Vancouver offices. More details of the review scope and approach are included in Section 2.

1.2 The Division contributes to OSFI's mandate by providing the Supervision Sector with technical and specialized actuarial assistance in risk assessing financial institutions (institutions) using OSFI's Supervisory Framework (Framework). A summary of the Framework is included in Appendix I.

1.3 The Division's resources are equally split between OSFI's Regulation and Supervision Sector (Supervision). In general, its responsibilities to internal and external stakeholders are to:

- provide specialized actuarial information and support services to the Regulation and Supervision Sectors with respect to the industry as a whole and specific insurance operations;
- oversee the development and delivery of appropriate knowledge transfer to supervisors and specialists with respect to actuarial issues and work;
- Interact with and review reports and work conducted by Appointed Actuaries and external reviewers. This role is particularly important due to OSFI's reliance on the Appointed Actuary (AA) pursuant to the Insurance Company Act (ICA) and to minimize duplication of effort in supervisory work;
- Encourage the Canadian Institute of Actuaries (CIA) to develop the components of a sound basis for OSFI's reliance on AAs, especially:
 - standards of practice, particularly for identified emerging risks;
 - practice or peer review, including feedback and advice to practitioners;
 - appropriate disclosure regarding actuarial work;
- Develop and maintain a system for periodically identifying and, where appropriate, evaluating emerging actuarial risks and for updating OSFI's methodology in response thereto; and
- Provide expert advice to OSFI in its international activities, particularly in the development of international insurance standards.

The Division's mandate and responsibilities are included in **Appendix II**.

Objectives of OSFI's Supervisory Process

1.4 OSFI uses a systematic risk-based methodology to supervise institutions. In its capacity as Supervision's actuarial support specialist, the Division is expected to be well grounded in the Framework's key principles, methodology, process and guidance, especially as it relates to actuarial matters. The methodology is described in the published Framework and in a number of Supervisory Guides.

1.5 The objective of the Framework is to assess the safety and soundness of an institution on a consolidated basis, to allow OSFI to intervene in a timely and effective

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manner where it considers an institution's risk management and control practices to be, or likely to become, imprudent or unsafe. It is expected that the Division will assist Supervision in consistently applying the Framework when risk assessing insurance institutions.

1.6 To ensure fairness within the financial services sector, OSFI has an obligation to ensure that its decisions are taken in a consistent and balanced manner. Since OSFI's methodology is risk based, it needs to make explicit choices as to what areas are of significant risk. If OSFI is called upon to defend its supervisory intervention, it needs to be able to demonstrate the reasonability of its actions based on the work that was done and the information available at the time. Accordingly, proper documentation of its risk assessment and intervention activity is crucial to the transparency of its supervisory approach.

1.7 OSFI's documentation standard is that "*A reader should be able to follow the facts through to the conclusion.*" This means that supervisors should document the linkage between their assessment of the institution's risk profile and the nature and extent of work done to support OSFI's intervention activity.

1.8 To ensure that there is minimal duplication of effort, OSFI places reliance on the opinion of the external auditor for the fairness of the financial statements and on the AA for the valuation of the policy liabilities. In addition, where appropriate, OSFI uses the work of third parties (i.e. the external auditors, AA and external (independent) actuarial peer reviewers) to reduce the work it would otherwise have to do to risk assess an institution.

2. Review Scope and Approach

Scope

2.0 The scope of the review was to assess the Division's processes, including divisional management's oversight over these processes, for supporting Supervision's Life Insurance Groups in risk assessing their institutions during the period April 2006 to March 2007. Our review included an assessment of the Division's:

- Management oversight framework, process and practices in:
 - Incorporating work into supervisory assessments and ratings;
 - Supporting supervision's reporting to stakeholders;
 - Reviewing all the companies' Appointed Actuary's Reports, DCAT Reports, par reports from demutualization and reports of external reviews and inform supervisors of significant areas that merit further investigation and to provide a basis for OSFI to continue to rely on appointed actuaries for the adequacy of policy liabilities and to use their work to modify the scope of its reviews, as appropriate; and
 - Transferring specialized knowledge to supervisory staff relevant to examination work.
- Application of the above management oversight framework, process, and practices supporting life insurance supervisors.

2.1 Our review was based on discussions with the Division's management and

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actuarial consultants, as well as OSFI's Life Insurance Supervision Group's Relationship Managers (RMs). We also reviewed a representative sample of the Division's supervisory work. Our overall conclusions and recommendations are included in Section 3 below, with detailed observations and recommendations presented in Section 4.

2.2 Consistent with the Treasury Board Policy on Internal Audit, the review was conducted in accordance with the Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing.

3. Summary of Observations and Recommendations

What is expected 3.0 OSFI's Framework requires Supervision and specialist support groups (including the Division) to leverage off each other's expertise. Accordingly, it is expected that both groups would work together to provide assessments that are consistent with OSFI's supervisory methodology, their areas of expertise and commensurate with the nature, scope, complexity and risk profile of the institutions they are supervising.

Summary of Observations

3.1 In our review of the Division's processes for providing Supervisory support to the life insurance supervisors, we found a number of characteristics that provide sound support to the Division in meeting its objectives, as well as some areas where changes could be made to facilitate efficiency and effectiveness of its support to Supervision. The implementation of the recommendations outlined below will require actions on the part of both the Actuarial Division, and Supervision to make the most effective use of each group's knowledge and expertise and to ensure that the work is integrated in a manner that makes the best use of each group's expertise.

3.2 We found that the Division's management oversight and processes were generally sound in:

- fostering a good working relationship with life insurance supervisors;
- responding to life insurance supervisors' requests for assistance in conducting on-site reviews;
- preparing Management Reports to institutions;
- providing ad hoc advice on technical issues;
- participating in quarterly monitoring activities and meeting with the institution's AAs and management as requested;
- interviewing newly appointed actuaries; and
- reporting to Supervision on the results of cross-sector reviews of emerging issues.

3.3 In general, the areas that need strengthening to ensure there is a consistent application of the Framework methodology, process and guidance include;

- the Division's roles, responsibilities, and accountability;
- the use of the work of the institution's risk management control functions and third parties;
- the execution of life insurance risk assessments and reporting;
- the quality control review process; and

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- knowledge transfer.

3.4 As these areas are interrelated in the supervisory process, the order discussed in the report is not intended to be a prioritization. These areas are summarized below.

Roles, responsibilities and accountability

3.5 The roles, responsibilities and accountabilities of the Division and between the Division and Supervision need to be clarified and broadly communicated, in order to fully utilize the expertise of both groups in carrying out the supervisory process for life insurance companies (i.e. monitoring and analysis, planning, execution, reporting and follow-up).

Use of the work of the institution's risk management control functions and third parties

3.6 For a more effective and efficient supervisory process, the Division's management oversight and processes need to reinforce the Framework's principle of leveraging off the work of the institution's risk management control functions (RMCFs) and third parties to modify the scope of supervisory work.

3.7 The Division's reviews of Appointed Actuaries Reports (AARs), Dynamic Capital Adequacy Tests (DCATs), External Peer Review reports (EPRs), and AuG 43 reports need to provide supervisors with more relevant, reliable and timely information of a risk assessment nature.

Execution of Risk Assessments and Reporting

3.8 The Division's onsite reviews of life insurance companies need to be more robustly planned and executed. Scope documents for the work to be performed should be prepared jointly by Division and Supervision staff and should focus on the key risks and RMCFs in the activity being reviewed. The scope document should clearly state how the work performed by third parties was used to modify the scope of the onsite reviews. The work performed by the Division should be carried out in accordance with the Framework and related supervisory guidance.

Quality Control Review Process

3.9 The Division needs to enhance its quality control process. Even though the work performed by the Division was reviewed for quality by the first level of management above the individuals performing the work (i.e. "one-up review"), this review did not have the required rigor and consistency that is needed to effectively detect work quality issues and to demonstrate the Division's overall accountability for quality of its work. As an additional check on quality of the work, there was limited evidence that Supervision considered whether the Division's work was consistent with the agreed and appropriate scope of the review and suitable for incorporation into the risk assessment. The concurrence on the scope and the execution of the work by the Division and Supervision ensures both groups share responsibility and accountability for the quality of work within their area of responsibility and field of expertise.

Knowledge Transfer

3.10 Although the Division contributes to the transfer of life insurance knowledge, its process is informal and not integrated with Supervision process improvement initiatives. A program that formally covers both knowledge sharing and transfer is needed. This

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would improve consistency in the application of the Framework methodology, process and guidance, which would improve the overall integration of the Division's work with the work performed by the supervisory team.

4. Overall Conclusion for the Review

Conclusion

3.11 In conclusion the Actuarial Division is well respected within OSFI and externally for its knowledge, expertise and advice it provides regarding life insurance regulatory matters. In its role of providing supervision support, however, consistent implementation of the supervisory methodology in the case of life insurance supervision has been a challenge for the Division. This challenge has been made more difficult by informal roles and processes, and by the staff changes and /or organizational changes experienced by the group. As a result, it was difficult, in many cases, to assess whether an informed reader can follow the facts and analysis through to the conclusions.

3.12 As noted above, many of the recommendations outlined in our review require the Division and Supervision to jointly identify solutions to consistently implement the Supervisory Framework methodology, process and guidance. These recommendations are intended to make full use of each group's area of expertise while respecting divisional roles, responsibilities and accountabilities within OSFI's matrix organizational structure.

Our observations and recommendations are detailed in **Section 4** of this report.

3.13 A&CS would like to thank all the members of the Actuarial Division and other Supervision Sector groups for their assistance during this review. Their cooperation and contributions were invaluable to the success of the review.

Senior Director, A&CS

Date

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Management's Response

The report, its findings and A&CS's observations and recommendations have been thoroughly reviewed by the Actuarial Division (AD). The recommendations will aid the Division in enhancing its operations in support of Supervision activities. Overall we appreciate the thrust of the report, and generally agree with its recommendations. We recognize that the intention of A&CS is to have OSFI enhance its operations.

Based on the observations and recommendations in the report, we have identified four overall themes for enhancement of procedures that we plan to proceed with: (1) provide assistance to the risk assessment and intervention function on the basis of the Supervisory Framework and increase risk-based orientation, (2) enhance quality controls, (3) implement a constructive challenge role with Supervision, and (4) enhance and make more effective the knowledge transfer with Supervision. Each of these themes is commented on below.

First, to help achieve these objectives, AD will update its official mandate so its stakeholders more clearly understand the roles, responsibilities and accountabilities of the division. Based on the recommendations of the report, this will involve some changes to the current relationship with Supervision and thus will require Supervision support.

A key component of the Supervisory Framework is that the supervisory work done by OSFI should be risk-based. The Division will work with Supervision to improve the efficiency of risk-based assessments of companies so as to more clearly identify key risk issues, both on a company basis and also across the industry. The AD welcomes the opportunity to participate more closely with Supervision in the development of the Knowledge of Business and also in the early planning for the AD services to be provided during a company examination. In order to achieve this goal, AD needs to be better integrated into Supervision's risk assessment process.

The AD agrees that it will enhance the quality control processes around the work it does for Supervision regarding the examinations of companies. Key results of this will be more robust documentation and tracking of the work done and the basis for the conclusions reached.

The AD agrees with the recommendation that it should assume a "constructive challenge" role with Supervision when identifying company and industry risks from its actuarial perspective. In doing this, we will continue to recognize the Relationship Manager's accountabilities.

The AD agrees that the knowledge transfer with Supervision should be enhanced and become more formalized than at present. This involves the AD transferring actuarial expertise knowledge to supervision personnel as well as the people in AD gaining additional knowledge on supervision tools, such as the supervisory framework.

As the report indicates, many of the issues and corrective actions require the participation and agreement of Supervision. We look forward to strengthening our partnership with Supervision by addressing the recommendations.

We appreciate the effort taken by A&CS to develop recommendations that will enhance the operations of the Division.

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5. Detailed Observations and Recommendations

Focus of the Review	<p>4.0 In this section, we discuss our observations and recommendations in relation to the Division’s Supervision support responsibilities, the Framework, and related supervisory guidance. The observations are based on a review of a representative sample of work performed by the Division to determine the extent to which it was achieving its objective of helping supervisors carry out their supervisory responsibilities. Observations and recommendations are discussed in the following order:</p> <ul style="list-style-type: none"> ▫ Roles, Responsibilities and Accountability; ▫ Division’s Planning Process; ▫ Monitoring and Analysis Process; ▫ Knowledge of Business and Supervisory Strategy Process; ▫ Use of Work of the Risk Management Control Functions and Third Parties Process ▫ Execution of Risk Assessments and Reporting; ▫ Quality Control Review Process; and ▫ Knowledge Transfer.
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Roles, Responsibilities and Accountability

What is expected	<p>4.1 In our documentation review and in discussions with Division and Supervision staff, we were looking for confirmation of the nature and extent to which the roles, responsibilities and accountabilities of the two groups were clearly communicated, understood and consistently applied in the supervisory process.</p> <p>4.2 In general, the Division’s stated objective is to contribute to Supervision’s risk assessment and intervention process by providing specialized actuarial expertise in:</p> <ul style="list-style-type: none"> ▫ identifying and drilling down into the financial institution risks and assessing the quality of risk management control functions; ▫ proactively monitoring and analyzing emerging issues and communicating the related implications to Supervision at the right level of detail; ▫ transferring knowledge of actuarial affairs to Supervision as appropriate; and ▫ Providing service in efficient and timely manner. <p>4.3 Another important responsibility of the Division is to review Appointed Actuary Reports, DCATs and External Review reports (“the actuarial reports”) and report to Supervision on any changes in valuation assumptions or methodology, or any other significant issues that merit further investigation by the supervisors.</p>
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Observations	<p>4.4 We found a good description of the Division’s Mandate and Responsibilities posted on OSFI’s internal network (See Appendix I). However, we found that the</p>
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Division's Mandate and Responsibilities are inconsistently communicated in various other documents. As a result, there is a lack of clarity in the expectations with respect to the nature and extent of the Division's support for FCG-Life and FIG-Life.

4.5 For instance, OSFI's *Framework for Exercising the Superintendent's Powers* (revised February 2007) does not explicitly state that the Division should provide technical assistance *to the risk assessment and intervention functions on the basis of the Framework* as is the case for the Regulation Sector – Pensions Plans and the other specialist groups in the Supervision Sector (e.g. credit risk, capital markets, financial services technology, etc).

4.6 In practice, we found that the nature and extent of the Division's supervisory work was driven by Supervision's requests. As well, the Division performs informal monitoring and analyzes industry-wide and global emerging risk; but it does not appear to communicate to supervisors the implications of these risks, as appropriate, for the individual institutions. Based on our discussions, several supervisors believe that a more formal and proactive Actuarial Division role would not be value-added to Supervision's monitoring activities. However, a less proactive approach may not fully take advantage of the Actuarial Division's value and ability to bring to bear its specialized expertise, knowledge and perspective in assisting supervisors in carrying out their responsibilities.

4.7 We also noted that the Divisional wide-range of supervisory support responsibilities are not fully reflected in the Division goal commitment documents for key personnel. As well, the staff changes and the availability of these key individuals during the review period may have compromised the Division's ability fully optimize its contribution to Supervision's process and for managing its day-to-day activities.

Recommendations

4.8 **In order to enhance the effectiveness and efficiency of the supervisory process, the Division's roles, responsibilities and accountabilities should be formalized and broadly communicated to ensure OSFI-wide awareness and acceptance of its role as an actuarial specialist function.**

4.9 **The Division's mandate should more clearly establish the extent to which it has authority to:**

- **provide technical and specialized support for the risk assessment and intervention functions from a prudential perspective on the basis of the Supervisory Framework;**
- **provide a “constructive challenge” role in its field of expertise throughout the supervisory process, as appropriate;**
- **proactively and regularly monitor, analyse and report on domestic and global emerging issues; and**
- **provide training (i.e. knowledge transfer) on actuarial matters to specialists and supervisors using OSFI's Framework and related supervisory guidance.**

4.10 **The process for establishing the Goal Commitment Documents for the Division's personnel should be reviewed to ensure that they align with the expectations with respect to the Division's roles, responsibilities, accountabilities**

OSFI Regulation Sector – Actuarial Division Life Insurance Review and day-to-day activities.

Division's Planning Process

- What is expected**
- 4.11 Strategic and business planning is a process to assess and set priorities to allocate resources required to deliver quality services. A plan is also the basis for coordinating the priorities and action plans with other dependent OSFI's sectors. Without a proper plan, the Division risks making decisions that are inconsistent with its and others sector's objectives, priorities and plans, as well as not having the appropriate staff to deliver timely and quality supervision support services.
- 4.12 In its Supervision support role, it is expected that the Division's planning process results in risk-based plan of all its key activities, which clearly align to the Supervision's planning process for developing risk-based supervisory strategies for institutions over the supervisory cycles. The objective of this process is to ensure that the nature, scope and extent of supervisory work (i.e. monitoring, analysis and on-site) provides adequate coverage for maintaining a current risk assessment of the institution's risk profile and to provide support for intervention actions.
- 4.13 In our review of the Division's planning process, we were looking for evidence that it has a developed planning process and it has prepared a multi-period risk-based plan, which;
- 5.0 risk prioritizes all of its activities (i.e. its universe) considering significant areas of risk raised by supervisors or the Division as part of the ongoing industry monitoring and industry studies and from reviewing actuarial reports and the resulting impact on institution-specific risk profiles;
 - 6.0 risk prioritizes reviews of actuarial reports within the context of providing timely and relevant information to supervisors;
 - 7.0 considers the nature and extent of monitoring and analysis needed for industry level and institution-specific significant issues, considering the industry cycle, emerging issues and the means to which to effectively transfer and store this knowledge for broader and future use;
 - 8.0 considers availability and use of resources for the planned activities including a transparent mechanism to appropriately adjust for resource gaps;
 - 9.0 has gone through a process to obtain concurrence from Supervision for its plan of activities, scope, timing and resource allocation as evidenced by a formal sign-off at the institution and sector level.

- Observations**
- 9.1 We found the Division developed annual plans based on Supervision's requests for institution-specific reviews of lines of business or specific "issues" and based on its own prioritization for reviewing actuarial reports (AARs, DCATs) (based primarily on the size of the institutions). However, we noted that these plans do not clearly include all the Division's supervisory work activities (including actuarial reports) for the current period and over the supervisory cycle. As a result, it was unclear as to the extent to

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which the scope for the planned work was: risk-based and in the context of the institution's risk profile; took into account the Division's broader view of industry-developments and emerging issues; considered the work done of the third parties (i.e. the Appointed Actuary, External Auditor) and the institution risk management control functions to modify the supervisory scope of work, as appropriate.

9.2 Although the Division prepared an annual resource plan, it did not include a resource gap analysis (i.e. capacity, resource requirements). As a result, it was not clear what resources the Division had committed for its supervision support role or whether or not the work could be done with the available resources. The Division indicated that in the past it was able to respond to Supervision's planned and ad hoc requests for on-site examination support, with few exceptions. However, we found that the Division was not always able to complete its plans for other activities.

9.3 We were informed that the Division informally discusses its plans with Supervision. However, in our review of the planning documentation (i.e. Annual Plans, Amend Plan, Supervision's resource allocation planning and supervisory strategy documents), it was difficult to follow the Division's and Supervision's support and rationale for the supervisory strategy and concurrence for the scope of work for the current period and over the supervisory cycle. The supervisory standards of practice require that where the supervision support resources are identified in the strategy, they should be approved at the appropriate level within the Regulatory Sector. We are aware that the supervisory planning process enhancements are underway, which would impact the Division's process as well.

Recommendation

9.4 **In order to ensure the Division provides appropriate, timely technical support for risk assessments and to develop its analysis of industry-wide emerging risks as input into the supervisory process, it should review its planning process for:**

- 10.0 **developing a multi-year integrated plan that is consistent and compatible with Supervision's plan and takes into account its specialized view of industry-wide and emerging risk;**
- 11.0 **developing, in consultation with Supervision, an integrated and transparent process to risk-prioritize all its activities, including a proper sign-off as evidence of concurrence,**
- 12.0 **increasing the leveraging of the work of third parties to modify the scope of work planned, as appropriate.**

Monitoring and Analysis Process

What is expected 12.1 The supervisory strategy is subject to revision if unforeseen events could potentially alter the risk profile of an institution and/or a number of institutions. Monitoring involves a regular review of institution-specific and industry-wide information to keep abreast of changes that are occurring in the institution business activities and operating environment. These changes may affect the level of risk and how risks are managed in an institution. Monitoring includes ongoing contact with the

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institution.

12.2 A stated objective of the Division is that it contributes to the supervision process by providing specialized expertise to monitor and analyze important industry-wide and global emerging risks and to proactively advise supervisors of important industry trends that may affect their overall assessment of risks and intervention strategies for an institution.

12.3 Based on this objective, it is expected the Division has a formal monitoring and analysis process for early detection of risk that may impact institutions and to impart knowledge to supervisors in a manner that is timely, risk-based, at the right level of detail so that it could be easily be integrated into supervision's process. In addition, this process could contribute towards building OSFI's reservoir of corporate knowledge that could be used for other purposes, such as for training, analysis of emerging trends and benchmarking studies, which would contribute towards a more proactive and timely supervisory process and intervention.

Observations

12.4 The Division has actively participated in the development of recent changes to International Accounting Standards and International Financial Reporting Standards.

12.5 The Division has taken a leadership role in certain risk areas. For instance, it has monitored and analyzed long-term interest rates used in actuarial valuations to determine whether the effect of a possible pandemic on capital was adequately addressed in the DCAT report.

12.6 We found, in general, the Division does not provide a written monitoring and analysis report on its views of emerging risk and industry trends. However, for the conglomerate group the Division participated in the supervision's quarterly monitoring meetings, responded to ad hoc requests and conducted special studies on areas of concern. For the non-conglomerates, the Division did not generally participate in the ongoing monitoring and analysis process at the institution specific level unless formally asked to do so. As a result of the informal process, based on our review of supervisory documentation and discussions, it is unclear how the Division's informal monitoring and analysis practices produced timely and risk-based knowledge of industry developments and emerging issues as a transparent input into the supervisory process.

12.7 Based on our discussions with some supervisors, their view is that if the Division were to have its own monitoring and analysis process it may not provide value-added as Supervision has a well-defined quarterly and year-end monitoring process and that the Division's best use of resources is to respond to supervision's requests. However, the Division should be more proactive to maximize the specialized and supervisory knowledge and perspectives they have to assist in assessing the increasingly complex and changing risk environment and for considering the increasing expectations from OSFI stakeholders for early identification of risk and to proactively monitor the impact on the institutions.

Recommendation

12.8 An integrated monitoring and analysis process to consolidate and disseminate OSFI's corporate knowledge of actuarial related emerging risks and industry developments would contribute towards a more efficient, effective and transparent supervisory process. In this regard, the Division should clarify its monitoring and

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analysis responsibilities (as stated in 4.9) and develop a formal process;

- 13.0 to proactively identify, analyse, consolidate and regularly communicate to Supervision its view of emerging risk and industry developments that may affect risk assessments, and
- 14.0 to assess how identified emerging risks and industry developments might affect specific institution's risk profiles and supervisory strategies.

Knowledge of Business and Supervisory Strategy Process

- What is expected**
- 14.1 Knowledge of business (KoB) is the process supervisors use to develop an inventory of the institution's activities from which significant activities are selected for risk assessment purposes. Identification and assessment of Significant Activities (SA) is fundamental to the Framework in that it identifies areas of supervisory concern so that OSFI can prioritize its supervisory work.
- 14.2 The information contained in the KoB document should help supervisors develop a risk-focused supervisory strategy for assessing each SA over the supervisory cycle (usually three to five years depending on the nature, scope, complexity and risk profile of the institution). This ensures that OSFI's assessment of the institution's risk profile remains current and facilitates an early identification of prudential issues.
- 14.3 The Division has a key role to play in the development and update of the KoB. Not only is its staff familiar with the risk profile of each institution based on their knowledge of the industry both here and abroad, and their review of the actuarial reports; but they also have an appreciation of the complexity of the valuation process and the controls needed to properly manage the process. Accordingly, we expected the Division to participate in the process to develop and update the KoB and the strategy for risk assessing the SAs, based on the nature, scope, complexity and risk profile of the institution.
- 14.4 In particular, for the purpose of this review, we were looking for evidence that the Division:
- 15.0 had a formal process for assessing actuarial risks at an industry-wide and institutional level to allow it to assist the Relationship Managers in identifying SAs and developing a strategy for assessing those activities; and
 - 16.0 had obtained the supervisor's concurrence and sign-off on the supervisory strategy and work planned (i.e. related to actuarial matters).

- Observations**
- 16.1 We found that the Division had a limited role in the development of the KoB, supervisory strategy, and institution-specific plans. In our review of the supervisory files, we were unable to clearly identify the nature and extent to which the Division participated in Supervision's planning process for developing the KoB and supervisory strategy.
- 16.2 Although the Relationship Manager has primary responsibility for ensuring that the KoB process is effective, we did not find evidence that the Division had challenged supervisors where the identification of significant activities was not sufficiently

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transparent and appropriate for the nature, scope, complexity and risk profile of the institution. For instance, in most cases we reviewed, the valuation of policy liabilities process was not identified as a separate enterprise-wide SA, which would have provided for a systemic assessment for supervisors to gain a sound understanding of this activity as undertaken by the institution and as an essential precursor to assessing its net risk. Rather, this SA was assessed within each line of business (LoB) (i.e., the assessment of the valuation activity's inherent risks and RMCFs was amalgamated with the assessment of market strategy, product design, pricing, distribution, underwriting, reinsurance, and claims administration). As a result, the risk assessment for a line of business (i.e. the valuation of policy liabilities process) was fragmented and / or combined different inherent risks and/or RMCFs assessments in such a manner that it made it difficult to properly assess how net risk for an activity was determined and reflected in the institution's overall risk profile.

16.3 The problem with the identification of SAs seems to have arisen because the overall approach to assessing the valuation activity in each institution had not been clearly thought through in a manner that was consistent with the Framework and related guidance. Increasing the awareness and use of Life Supervisory Guide L3 – *Valuation of Policy Liabilities*, will foster a consistent understanding and application of the supervisory methodology for assessing the valuation activity.

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- Recommendation** 16.4 We recommend that the Division develop a formal process for its participation in the development and update of the KoB and related supervisory strategy for the valuation activity, as well as any other activity for which its input would be useful. A more formal and integrated KoB process should address, at a minimum:
- The Division's and Supervision's accountabilities, and
 - The nature, extent and timing of the necessary information to be provided and/or reviewed by the responsible parties to facilitate its incorporation into the supervisory work.
-

Use of Work of the Risk Management Control Functions and Third Parties Process

What is expected 16.5 One of the key principles of the Framework is, *where possible and warranted*, to use or leverage off the work of the institution's oversight functions (e.g., Internal Audit, Risk Management, Senior Management, Board) in assessing the quality of Operational Management, in order to reduce the scope of the work that would otherwise have to be done to risk assess the institution.¹

16.6 Another related principle is to use, *wherever possible and warranted*, the work of Third Parties (i.e. Appointed Actuaries, External (Actuarial Peer) Reviewers and External Auditors) to reduce the scope of supervisory work.

16.7 A consistent and appropriate application of these key principles allows OSFI to

¹ OSFI Supervisory Guide G3- Risk Matrix – A walkthrough of the Risk Matrix and related ratings, pg.8-9

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focus its resources in areas of higher residual risk.

16.8 Insurance institutions submit actuarial reports to OSFI for supervisory purposes and other reasons. An important responsibility of the Division is to review all actuarial reports and to advise Supervision of the results of its review. These reports should be used not only to identify prudential issues and concerns about the valuation of policy liabilities, but also areas where the scope of supervisory work could be modified to take advantage of the work performed by third parties and the institution's oversight functions.

16.9 In our review of the Division's process, we were looking for:

17.0 Reviews of actuarial reports that were timely, appropriate from a Framework supervisory perspective, and highlighted matters that Supervision would find useful for risk assessing the institution, as appropriate.; and

18.0 A review of the work undertaken by the RMCF's and/or third parties and how such work was used to modify the scope of the work to be performed during onsite reviews, as appropriate.

Observations

18.1 In our review of the Division's process for reviewing actuarial reports, we noted that:

19.0 Although the Division had developed procedural manuals and templates for conducting desk and onsite reviews, the manuals did not adequately refer to the Framework methodology and/or relevant supervisory guidance and the templates did not always provide the kind of information that supervisors would find useful in risk assessing their institutions. For instance, the review of the DCAT reports was in a format that rated the quality of the report and its compliance with CIA standards. While this might have been helpful in providing feedback to the industry and other external stakeholders on the quality of the actuarial reports (i.e. DCATs), it did not provide supervisors with risk-based information that would be useful in risk assessing an institution's profile from a prudential perspective.

20.0 The Division does not appear to review and gives supervisors advice on whether the MCCSR filings raise prudential and/or capital adequacy concerns.

21.0 There is little evidence that the Division's actuaries asks for or examine the Appointed Actuary's supporting memorandum as part of their support to supervisors.

22.0 The Division has not yet developed a clear and documented process to review External Reviews and External Auditor reports per CICA AuG43. These reports are reviewed as received, as time permits, but there is no guidance on how the reports can be used to help in the supervisory process. We noted at the time of our review that the CICA AuG 43 External Auditor audit requirements are new for 2006 and that the Division is considering what is needed in terms of process enhancements.

23.0 Not all actuarial reports are reviewed due to resource constraints and supervisors were not advised where the review was not done as expected or planned.

24.0 Where the Division identified areas needing further follow-up by

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Supervision, there was no acknowledgement mechanism to evidence that the supervisors received and acted on the information.

Recommendation

24.1 The Division should review its methodology, processes and reporting practices for the review of actuarial reports to better ensure its approach is from a prudential perspective, based on the Framework and provide value-added and timely information to the supervisors for the purpose of risk assessments and intervention.

24.2 In particular, it should;

25.0 Establish and communicate to the supervisors its prioritization criteria, scope and timeline for the review of actuarial reports and discuss any subsequent changes to the initial plans;

26.0 Enhance the process and outputs to ensure its reviews are more risk-based, the information is presented in a manner that can be used as input into the various phases of the supervisory process i.e.; monitoring, analysis, planning and risk assessments and, where possible, highlight areas where the work of the third parties and RMCFs could be used to modify the supervisory scope of work; and

27.0 Discuss with Supervision and Practices what training, processes, practices and tools are needed to enhance a consistent application and integration of the use of work of third parties and at what juncture in the supervisory process (i.e. monitoring, analysis, planning, risk assessments, etc.).

Execution of Risk Assessments and Reporting**What is expected**

27.1 It is expected the Division clearly and consistently applies the Framework and guidance when providing supervisory support on-site risk assessments. Because of the complexity in holistically assessing an institution's risk profile in the context of safety and soundness, a systematic, risk-focused and forward-looking approach is required regardless of who contributes to the risk assessment process. The exercise of sound specialized and supervisory judgement is critical in developing a supervisory approach for performing risk assessments. Therefore, it is important that supervisor's and actuarial consultant's judgements are consistent with the Framework methodology (e.g. the consistent use of the "risk equation" to arrive at the net risk for a significant activity) and transparent (i.e. reasoned documentation of supervisory judgements) throughout the risk assessment process and the context of nature, size, complexity and risk profile of the institution. As well, the use of work of third parties should be considered to modify the scope of work throughout the supervisory risk assessment process.

Observations

27.2 Due to established practices, expectations and resource constraints, a generally accepted supervision practice is that the supervisor makes the decision as to the scope and extent of work as s/he has the primary accountability for the risk assessments. Although supervisors are generally satisfied with the Division's support to-date and the

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current practice, it would be prudent for the Division to proactively and explicitly bring to bear its specialized knowledge and informed judgment to ensure that the scope and extent of work is appropriate for the nature, size, complexity and risk profile of the institution. This was not clearly demonstrated in our review of the Division's supervisory work documentation.

27.3 For the sample reviewed, Supervision's scope documents for the work to be performed by the Division were either not provided to the Division or did not clearly specify what work the supervisor wanted the Division to do. As a result, the Division often performed a standard review of the pricing and valuation processes. Although, this was done in consultation with the supervisors, a standard review seemed to be a fallback approach, rather than based on identified risk and area of concern. This is not conducive to an effective and efficient use of resources through a sharper focus on the identified risks in the institution's significant activities.

27.4 We also found that it was difficult to follow the risk assessment and supporting supervisory judgments for significant activities. In particular, although the valuation of actuarial liabilities process could have pervasive impact on an institution's operations and safety and soundness, it was assessed as part of the various lines of businesses. As a result, it was difficult to follow the risk assessments and there was inconsistent application of the supervisory key principles and concepts, as evidenced by;

28.0 Key inherent risks² were not rated (i.e. operational risk³) or were incorrectly combined with insurance risk for a number of activities i.e. pricing, underwriting and valuation;

29.0 There was lack of clarity in the distinction between operational management and the RMCF's; and

30.0 The work of RMCFs and third parties was not generally considered to assess the effectiveness of operational management for the identified risk and areas of concern.

30.1 The Division uses the Supervisory Examination Note to document its risk assessments. This document is not structured based on the Framework methodology using the Frameworks to guide to the assessment of the significant activity based on the risk equation components (i.e. the activities inherent risks and the relevant operational management and RMCFs). This may have contributed to the inconsistent application of the Framework and the difficulty in demonstrating that a systemic and transparent approach was applied by using the risk equation to arrive at the net risk assessments for the significant activities. This also may also make it difficult for the supervisors to incorporate of the Division's assessments into their risk assessments

30.2 In addition, there seems to be limited use of the relevant supervisory guidance, which if used, may improve the quality and consistency in the risk assessments. For instance, we noted that there was limited, if any, reference to the Supervisory Guide L3, Valuation of Policy Liabilities, when assessing the valuation of policy liabilities process. This guide identifies the type and indicators of inherent risks in the activity, for developing expectations of key controls and assessing the quality of risk management.

² The Framework (Appendix 2) provides a description of the inherent risks categories.

³ The Framework defines the operational inherent risk in a significant activity as the risk that arises from problems in the performance of business functions or processes. Exposure to this risk can result from deficiencies or breakdowns in internal controls or processes, technology failures, human errors or dishonesty and natural catastrophes.

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- Recommendations**
- 30.3 **It is recommended the Division**
- 31.0 **review its supervision support processes and intensify its efforts to develop a consistent and integrated application of the Supervisory Framework and guidance to better coordinate its work with Supervision.;**
- 32.0 **consider taking a constructive challenge role in risk identification and assessments where actuarial expertise is essential, while recognizing the Relationship Manager’s accountability.**
-

Quality Control Review Process

What is expected

32.1 Quality Control (QC) is a key component of the supervisory process. Supervisory Guide G-19, “*Review of Supervisory Work*” provides the expectations to support an effective execution of the quality control review process. It states that, “*reviewing supervisory work is a key responsibility of Supervision management at each step in the supervisory process to:*

33.0 *Ensure the consistent application of OSFI’s supervisory methodology,*

34.0 *Mitigate OSFI’s supervisory risk, and*

35.0 *Develop of supervisory staff.”*

35.1 Although the guide refers to “Supervision”, it is intended that the specialist groups, in their supervision support role, apply the supervisory guide.

35.2 In a rapidly changing and complex environment, the Division requires staff with the relevant skills, knowledge, experience and ability to perform in-depth analyses and apply reasoned judgment within short timeframes on complex issues requiring specialized actuarial knowledge. As a result, the concept of continual training, development and coaching of staff must be embedded in the Division’s ongoing quality control process.

35.3 In our review of the Division’s supervision support work, we were looking for evidence that;

36.0 There was a proactive and transparent “one-up” review of work performed and a proper disposition of queries throughout the process,

37.0 The quality review process was effective in detecting work quality issues and identified opportunities to coach staff, and

38.0 The review was done consistent with the expectations set out in the Supervisory G-19 Guide.

Observations

38.1 During our review, we noted that the Division’s quality assurance process in their supervisory support role needs strengthening to provide for a more transparent quality

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control review process and to enhance the quality of the work. Even though the work performed by the Division was being reviewed for quality assurance purposes, there was significant differences in the quality of work (level of detail, usefulness for risk assessment, clear linkages and incorporation to supporting and scope of work documentation) and the extent to which it adhered to the Framework and related guidance.

38.2 Since the only confirmation of quality assurance was an e-mail acknowledgement of one-up review and approval, therefore, it was not clear as to the nature of neither the review performed nor whether the review uncovered any concerns about the way the work was carried out. Had they been, it could as served to train staff on what needs to be done.

38.3 There was no formal sign-off process or indication that the supervisor had reviewed the Division's work against the scope and for consistency with the Framework.

Recommendation 38.4 **In order to enhance the quality control review process, we recommend the Division:**

39.0 **Enhance its implementation of the Supervisory Guide G19 –
*Review of Supervisory Work***

40.0 **Enhance continual development of staff as part of the quality control review; and**

41.0 **Provide mandatory training on the Framework and supervisory guidance given the observations throughout the report.**

Knowledge Transfer

What is expected

41.1 In providing support to supervision, the Division stated that it strives to impart to Supervision personnel specialized knowledge that is necessary for their mission and at the right level of detail.

41.2 In order for a transfer of knowledge process to be effective, there should be a process that identifies and addresses the gaps between the actual knowledge levels and levels of knowledge considered necessary based on the business complexities inherent in the various areas of OSFI supervision. Such a program would cover both knowledge sharing and knowledge transferring matters, with a view to improve integration of the Division's work with the work performed by the supervisory teams.

41.3 We expected that the Division have in place a defined program and process for knowledge transfer and knowledge sharing, which considers leveraging off Supervision's initiatives as appropriate to achieve integration of process and efforts. For instance, we noted that in the past year, Supervision has undertaken a number of initiatives to enhance its application of the Framework and supervisory process, which includes a training program for supervisors. We expected that the Division had participated in these initiatives. Achieving a consistent application of the supervisory methodology in a matrix organization requires a concerted effort to integrate important processes and practices across supervision and specialist groups.

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Observations

41.4 The Division's process to transfer specialized knowledge on areas of risk and concerns to the supervisors is currently on an ad hoc basis. As discussed in the monitoring and analysis section above, the Division's informal participation in the quarterly monitoring process does not lend to timely communication of risk and areas of concerns to others and results in a lost opportunity to build corporate knowledge in the actuarial matters.

41.5 We found a good example where the Division staff provided training to supervisors and demonstrated a sound understanding on what is expected in the application of the Framework. These individuals could be excellent mentors for bridging the knowledge gaps and perspectives within the Division and across Supervision staff.

41.6 The Division's nature and extent of knowledge transfer through its interaction with FCG-Life conglomerates and FIG-Life non-conglomerates is significantly different. The Division has considerably more interaction with the conglomerate than non-conglomerate supervisors, which provides different levels of knowledge sharing.

41.7 Although the Division actuarial consultants work as "one team" with the supervisors on on-sites examination, there is inconsistent application of the supervisory methodology and process. It seems that there is limited ongoing cross-training.

41.8 The use and awareness of Supervisory Guides by the Division's staff need to be encouraged and evidenced.

41.9 The Division has not participated in the Supervision's Framework and process initiatives to ensure that its processes and practices are integrated with Supervision and that it takes the opportunity for cross training with the Division and across the supervisory teams.

Recommendations

41.10 In addition to the observations and recommendations made throughout the report, the Division should ensure it develops a formal training program by engaging others as necessary (i.e. HR Professional Development Division, Supervision) to ensure there is timely transfer of knowledge on actuarial areas of risk and concerns as they arise.

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Appendix I – A&CS Review Criteria – Supervisory Framework

The objective of OSFI's supervisory process is to assess the safety and soundness of Federally Regulated Financial Institutions (FRFIs) on a consolidated basis, and to provide early warnings of issues to allow OSFI to intervene in a timely and effective manner where OSFI considers an institution's practices to be, or likely to become, imprudent or unsafe.

The supervisory methodology described below sets out the elements and related guidance of OSFI's Supervisory Framework (SF) criteria that will be the basis for A&CS assessment of supervisory activities. The SF was developed by OSFI's Practices Group and has been in place since 1999.

OSFI uses a disciplined, institution focussed, risk-based methodology to supervise FRFIs. The methodology is described, at a high level, in the Supervisory Framework, and in more detail in a number of Supervisory Guides. Where appropriate, supervisors "use the work" of the institution's Risk Management Control Functions (RMCFs or Oversight Functions) to help to assess the institution's effectiveness in managing its risks. OSFI's primary objective in assessing the RMCFs is to determine the extent to which it can use the work of these control functions to ensure that appropriate controls are in place and are operating effectively at the Operational Management level in the institution. OSFI places significant emphasis on the role of the Board of Directors to oversee, and on the role of Senior Management to manage, the business in a prudent manner. In addition, OSFI relies on the opinion of the external auditors with respect to the fairness of the financial statements. Similarly, OSFI will continue to rely on appointed actuaries for the adequacy of policy liabilities and will use their work to modify the scope of its reviews.

The methodology requires supervisors to understand the institution's environment, industry, and business profile in order to develop an inventory of the institution's activities. Since the methodology is based on assessing management effectiveness, activities are grouped along the line of accountability and reporting in place within the institution. Explicit decisions on the significance of each activity to the institution, based on both qualitative and quantitative factors are made. Generally, activities considered important to the achievement of the institution's business objectives are considered "Significant Activities" (SAs) for assessment purposes. Having identified the SAs, supervisors assess the level of risk inherent in the activities and the quality of risk management to arrive at the Net Risk and the direction of risk for each SA. The assessment of the level of inherent risk enables the supervisors to build expectations of the type and rigour of controls necessary, both at the Operational Management and Oversight levels, to mitigate the risks inherent in the activity. Accordingly, the assessment of the quality of risk management involves a comparison of these expectations with what is in place at the institution. The methodology also requires an assessment of the overall effectiveness of each of the applicable Oversight Functions of the institution.

Once the Net Risk of all of the SAs has been assessed, the materiality of each activity is taken into account to arrive at the Overall Net Risk for the institutions as a whole. Then the amount and quality of the institution's capital and earnings are considered to arrive at the Composite Risk Rating.

Section Notes are used to document the information, analysis, and assessments of the SAs and the applicable Oversight Functions. These assessments are then summarized in the Risk Assessment Summary (RAS). The RAS is intended to provide a high level understanding of the institution's overall risk profile. Supervisors should develop a supervisory strategy with sufficient coverage such that the material activities of the institution are reviewed over a reasonable period of time (e.g. three to five years). The strategy should give appropriate priority to reviewing the high Net Risk activities since they are likely to have the most impact on the institution's risk profile.

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Appendix II – Actuarial Divisional Mandate and Responsibilities

Divisional Mandate

To ensure that appropriate actuarial knowledge, advice and standards are applied in the total regulatory and supervisory systems governing federal financial institutions so that policyholders are safeguarded from undue loss and public confidence in the financial services system is enhanced.

Note that:

- Knowledge and standards can and must be applied by non-actuaries in both companies and OSFI;
- The total regulatory and supervisory systems include the Appointed Actuaries, Auditors and the standards that apply to them in their work; and financial institutions are not restricted to insurance companies, but do not include pension plans.

Divisional Responsibilities

- To oversee the development and revision of processes and programs for evaluation of actuarial work received by OSFI with respect to FRFIs.
- To oversee the development and delivery of appropriate training to supervisors, regulators, CIA, and specialists with respect to actuarial issues and work.
- To complete specific reviews of actuarial work carried out with respect to FRFIs:
 - a) to assist in the supervision of financial institutions;
 - b) to assist in the evaluation of proposals that require permission by OSFI;
 - c) to assess emerging risks;
- To produce benchmark studies to compare approaches in specific institutions with industry norms.
- To strategically influence the Canadian Institute of Actuaries to develop the components of a sound system for OSFI's reliance on Appointed Actuaries, especially:
 - a) standards, particularly for identified emerging risk areas;
 - b) practice or peer review, including feedback and advice to practitioners;
 - c) appropriate disclosure re actuarial work.
- To develop and maintain a system for periodically identifying and, where appropriate, evaluating emerging actuarial risks and updating OSFI methodologies in response.
- To develop and maintain developmental human resource processes to select top quality recruits, provide needed technical and managerial training and on-the-job growth to team members, and provide timely and appropriate performance feedback on an ongoing basis.
- To develop and maintain streamlined and effective systems for business planning, project management, and time reporting.
- To develop and maintain internal standards and controls for Divisional management of workflow and expenditures.
- To deal effectively with other regulators, industry and professional groups to achieve OSFI objectives, build enduring relationships, and enhance OSFI's image.
- To continuously acquire relevant actuarial knowledge and introduce it into OSFI's supervisory and regulatory practices.