Office of the Superintendent of Financial Institutions Canada | Bureau du surintendant des institutions financières Canada

SEPTEMBER 2012

LIFE INSURANCE
Regulatory Framework

OSFI
BSIF

Canada

Table of Contents

Introduction

Canada's life insurance regulatory framework is recognized as being strong, both domestically and internationally. It has proven its resiliency over time and through many economic cycles. However, life insurance companies and the Office of the Superintendent of Financial Institutions Canada (OSFI) alike are operating in an economic environment that is more dynamic, volatile and interconnected than in the past. This requires a greater awareness and management of risk by companies, industry stakeholders and OSFI.

This document provides life insurance companies and industry stakeholders with an overview of OSFI's current thinking on initiatives affecting life insurance companies. Canada and Canadians have benefited from a strong life insurance industry and a flexible and effective regulatory framework; our initiatives to enhance the regulatory framework aim to ensure this continues.

Background

Over the past several years, Canadian life insurance companies have made significant progress in their governance and oversight processes to better identify, measure, manage and price their risk-taking activities. They have done so in spite of many challenges, including the global economic crisis, weak equity markets, very low interest rates, competitive pressures and continuing international regulatory and accounting developments. Life insurers and reinsurers have been, and will continue to be, affected by these issues in different ways, not all of which are predictable. Nonetheless, stakeholders expect life insurance companies to continue to be competitive and viable in this environment of increased complexity and uncertainty.

During the same period, significant regulatory developments have affected deposit-taking institutions. OSFI recognizes that life insurance companies are in many ways significantly different than banks, particularly due to the long-term nature of traditional life insurance business. Therefore, in considering these developments, OSFI will not indiscriminately implement any of them (e.g., Basel III) into the life insurance regulatory framework. We also recognize that changes to companies' risk management, governance and oversight processes and to OSFI's regulatory framework must be evolutionary rather than revolutionary in nature.

Although Canada's regulatory framework for life insurance has responded well in the face of global financial turmoil, OSFI and the industry must continue to learn and adapt to changing circumstances and practices, and implement improvements where needed. Consequently, OSFI's focus for the next few years will be on putting many of these lessons into practice.

Purpose and Scope

OSFI's mandate is to protect policyholders and creditors, but we are not alone in our pursuit of this goal. Industry associations and life insurance companies also share this objective, and it is important that we all work together to maintain a regulatory system that has policyholder and creditor protection as its focus.

OSFI sets the minimum regulatory requirements and expectations to support policyholder and creditor protection, giving due regard to the need to allow institutions to compete effectively. As healthy companies are best situated to protect policyholders and creditors, OSFI is mindful of the impact of its requirements and expectations on competition domestically and internationally. Insurance regulators in other jurisdictions pursue similar goals but with different legislative and policy tools and with different economic experiences and conditions. OSFI will consider the pace, scope and impact of reforms when renewing the regulatory framework, to ensure that we are able to incorporate best practices, and limit – to the extent practical – unintended consequences and an uneven playing field.

This paper shares OSFI's current priorities with respect to a number of components of the life insurance regulatory framework. The degree of development on the issues discussed in this paper varies; for many issues the consultative process has not yet been completed or, in some cases, even begun.

OSFI wants stakeholders to understand our perspective, to encourage their participation in policy development, and to allow the industry to plan for change.

It is our hope that in laying out our initiatives, it will help industry stakeholders understand OSFI's perspective, thereby allowing for a deeper and more meaningful discussion and participation in the policy development process. It will also allow the industry to plan for the upcoming changes.

The initiatives outlined in this paper are key elements in the evolution of OSFI's regulatory framework, the aim of which is to achieve the following broad objectives:

- Life insurance companies' governance infrastructure and culture fully oversee their risk-taking through increased integration between risk measurement, risk management and pricing for risk.
- OSFI's regulatory framework continues to support and complement this risk-governance and information-sharing culture.
- Life insurance companies provide transparent information, allowing stakeholders to better understand the insurance business, understand companies' risk-taking activities and challenge institutions to continue to better measure and manage their risks.

To achieve these objectives, OSFI will introduce enhancements to the regulatory framework for life insurance companies through:

- A revised Corporate Governance Guideline, as well as other new guidance which will address how companies should approach their own risk and solvency assessments (ORSA)
- Revised regulatory capital requirements guidance that:
  - Measures risks at a similar level of confidence
  - Incorporates new risks not explicitly covered by the current framework
  - Accommodates smaller companies, as well as larger, more complex companies
  - Considers developments in actuarial and economic capital theory
  - Links risk measures to the quality of capital available to absorb losses
  - Takes into account the interaction between risks (diversification/concentration)
  - Reflects effective hedging and other risk mitigation practices
- Information disclosures to support the revised regulatory capital requirements

The following sections provide more information on OSFI's plans, direction and timelines for each of these initiatives. Many of these are interlinked, as developments in one area can often impact other areas. OSFI will endeavour to keep the initiatives co-ordinated, both in terms of timing and adjusting as new developments (domestic or international) emerge. OSFI is monitoring international initiatives currently under development (by the International Accounting Standards Board (IASB) and the International Association of Insurance Supervisors (IAIS)) that would likely impact the scope and timing of our own domestic initiatives.

Annex A provides a summary of the key milestones.

Impact of These Initiatives

OSFI's initiatives will have the following impacts:

Policyholders, Creditors and Other Stakeholders

- Policyholders and creditors will continue to have a high level of protection.
- Policyholders, creditors and industry stakeholders will be better able to conduct their own assessments of a company's risk-taking activities. This will help them hold companies accountable.
- Policyholders, creditors and industry stakeholders may have improved confidence that life insurance companies can withstand major economic or other shocks.

Life Insurance Companies

- Boards of directors may need to be augmented with a broader set of skills and will be better equipped to hold management accountable for the company's risk-taking activities.
- Companies may have to increase resources in governance and risk management.
- Capital levels may change due to internal capital targets set by the board of directors.
- A company may not experience a major change in its total capital held, but a reallocation of regulatory capital to various risks or business lines may occur, which may have implications for business models and strategies.[1]
- Capital will improve in terms of its ability to absorb losses, from the perspective of both a "going concern" and a "gone concern" basis.
- Companies should be able to continue to price risk in a competitive and effective manner.

OSFI

- OSFI will monitor the progress of these initiatives to ensure they adjust to new developments, remain consistent with each other and that implementation is co-ordinated.
- OSFI may need more specialized resources as these initiatives are incorporated into our regulatory and supervisory frameworks.

In addition to these impacts, consultation and communication is key to successful completion of these objectives. This means:

- Companies and industry stakeholders will need to keep abreast of OSFI initiatives.
- Companies and industry stakeholders will be asked to provide comment at different stages in the development of these initiatives.
- OSFI will provide sufficient opportunities for industry stakeholders to contribute and be heard.
- OSFI is committed to respond to feedback, and will explain the rationale for our decisions.

[1] OSFI is approaching the review of the regulatory capital requirements with the belief that, in aggregate, the industry currently has adequate financial resources (total assets) for its current risks.

1 Risk Management and Governance

Although life insurance companies know their business best, they must operate within a framework of risk oversight and regulation.

OSFI has a mandate to protect the interests of policyholders and creditors of the insurance companies it supervises. OSFI's revised life insurance regulatory framework will more explicitly emphasize the principle that companies have primary responsibility for measuring and managing their risks. Therefore, OSFI's approach to risk management and governance will be primarily "principles based" and applied consistently, as is appropriate, to all federally regulated financial institutions.

Guidance relating to governance, a company's ORSA, and market transparency all seek to underscore that the primary responsibility for the safety and soundness of financial institutions rests on the shoulders of those most familiar with the company and its risks: senior management and the board of directors.

a. Enhancing Corporate Governance

Financial institutions should have robust governance structures and processes that provide appropriate oversight of their risk-taking activities. Although the insurer's board of directors has a responsibility to establish and oversee sound governance, OSFI provides guidance on governance practices for all federally regulated financial institutions through the Corporate Governance Guideline, and detailed governance assessments (cross-system reviews).

At the heart of sound risk management are strong, diverse and knowledgeable boards of directors and management that operate in a culture where risks and challenges are clearly communicated. Deficiencies in corporate governance can lead to the assumption of unknown or unquantifiable risks. For life insurance companies, business and risk decisions often have long-term impacts. Understanding and managing these long-term impacts is nearly impossible if corporate governance structures and processes do not provide accurate, timely and clear information about the risks to which life insurers are exposed.

In addition to expectations that will be outlined in the revised Corporate Governance Guideline, OSFI expects that companies will have implemented more effective risk governance practices and processes, taking into account the nature, complexity, strategies and risk profile of their respective institutions.

We recognize that different institutions will implement different governance structures. Our guidance, and related work, is meant to explain our expectations without being overly prescriptive in terms of how a company implements them. OSFI will assess the effectiveness of each institution's governance practices, with an emphasis on risk governance.

OSFI issued a draft revision to the Corporate Governance Guideline for public comment in the summer of 2012.

b. Promoting Own Risk and Solvency Assessment (ORSA)

Each institution has its own risk appetite and history of risk-taking, which can differ significantly from company to company due to differences in the type and concentration of the risks undertaken. The minimum capital requirements set in OSFI's regulatory framework may not be adequate to address this institution-specific risk-taking, as the regulatory capital requirements are based on industry averages which, at any point in time, may not fully capture new risk exposures or product developments. For this reason, institutions should have their ORSA process. Life insurance companies should not simply rely on minimum regulatory capital requirements as a proxy or as a starting point for measuring their own risk profile.

ORSA represents an insurer's own view of its risks and solvency requirements. A company should employ appropriate processes that reflect the nature, scale and complexity of its own risks. These processes should assess, quantify and manage risks using, where appropriate, internal capital models, stress tests and other measures that reflect the company's unique risk profile and risk concentrations. Senior management is responsible for designing and implementing the institution's ORSA, which the board will then oversee.

There are international initiatives by other insurance regulators to introduce ORSA expectations in their jurisdictions. Leading Canadian institutions have already begun to develop and adopt processes in response to these initiatives. OSFI encourages Canadian insurers to continue their progress in this area.

OSFI's objective is to provide sufficient guidance to allow life insurers to self-assess whether their internal capital position is adequate and is likely to remain so in the future. An additional objective is for the company to have a clear understanding of the interrelationships between its risk profile and its capital needs. This guidance will be provided in an ORSA Guideline which will describe principles for setting the company's internal capital target(s). The guideline will also describe OSFI's expectations with respect to reporting and controls that should be established to ensure the integrity of the ORSA process.

OSFI's objective is to provide sufficient guidance to allow life insurers to self-assess whether their internal capital position is adequate and is likely to remain so in the future.

ORSA should not be seen as an OSFI compliance requirement but as a sound business practice. This will be reflected in the principles-based approach OSFI will outline in the ORSA Guideline. The ORSA Guideline will build on existing industry practice and OSFI guidance while considering international practices, in addition to seeking input and perspective from Canadian industry stakeholders.

OSFI plans to issue a draft ORSA Guideline for public comment in the fall of 2012. The final guideline would then be issued in 2013, with implementation in 2014.

c. Incorporating the Use of Internal Models in the Determination of Regulatory Capital Requirements

Life insurance companies develop their own analytical tools, processes and methods to assess their risks which often include the development of internal models. Companies use these internal models for many purposes, including obtaining a better understanding of the risks in their particular blocks of business and for setting internal target capital levels.

Internal models can also be used to determine regulatory capital requirements, subject to regulatory approval. At present, internal models can only be used to determine the regulatory capital requirement for segregated fund guarantee risk by those companies that can demonstrate the capability to do so. OSFI has specific guidance covering the use of internal models in this circumstance.

OSFI's first objective regarding the use of internal models in determining regulatory capital requirements is to update the guidance for segregated fund guarantee risk.

In the future, OSFI may eventually consider the use of internal models for other risks. However, OSFI plans to

OSFI's first objective regarding the use of internal models in determining regulatory capital requirements is to update the guidance for segregated fund guarantee risk.

take an evolutionary approach to incorporating other models into the regulatory framework for the setting of minimum regulatory capital requirements. Initially, OSFI would use information from these models to inform us about the risks that institutions face and the reasonableness of their own internal capital target levels. In the longer term, these models may eventually qualify to be used, with limitations and/or subject to floors, for measuring minimum regulatory capital requirements after we gain experience in their use.

OSFI is developing general and specific criteria that insurers will have to meet to use internal models for determining regulatory capital requirements. The guideline will be comprehensive and will incorporate existing guidance.

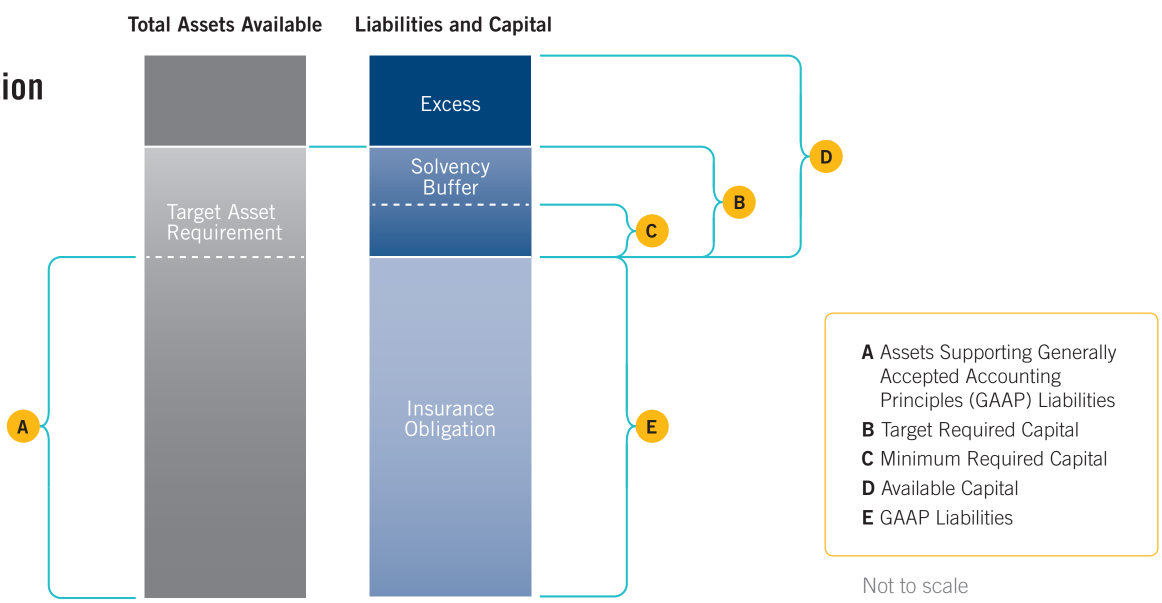
OSFI plans to issue a draft guideline for public comment in the summer of 2014.

2 Evolving Regulatory Capital Requirements

Regulatory capital requirements provide a minimum safety net of policyholder and creditor protection. For regulatory capital requirements to remain effective they need to continue to evolve to be more risk sensitive, to be responsive to industry developments (products, processes) and to provide a high level of protection for policyholders and creditors.

The following graph illustrates the relationship between a company's total assets and required capital (minimum and target), available capital and the total asset requirement (TAR) in the revised regulatory capital requirements.

Graphical Presentation of the Total Asset Requirement



Proposed accounting changes, evolving solvency capital developments in other jurisdictions and the global financial crisis have added to our motivation to complete this in-depth review.

The objective of this review is to improve our regulatory capital requirements by:

Taking a More Comprehensive Approach

- Take into account the total financial resources and requirements of the company (TAR)

Improving Risk Measurement

- Measure risks at a similar confidence level
- Be sensitive to the risks taken on by the company, including new products and product features
- Accommodate smaller as well as larger, more complex companies
- Recognize the quality of capital available to absorb losses on both a "going concern" and a "gone concern" basis
- Explicitly incorporate operational risk

Taking into Account Specific Integrations and Considerations

- Take into account the interaction between risks (diversification/concentration)
- Reflect the impact of effective hedging and other risk mitigation activities

OSFI is approaching this review with the belief that, in aggregate, the industry currently has adequate financial resources (total assets) for its current risks. However, all the changes taken together have the potential to impact the results for individual companies. We are also developing a new methodology for segregated fund guarantees to determine the appropriate level of regulatory capital required to support those liabilities.

The revised regulatory capital requirements are expected to be similar in many respects to the current regulatory framework, namely:

- The starting point will be the audited financial statements of an insurance company, complemented by Canadian actuarial standards.
- Companies will continue to be able to use an approved internal model (subject to revised criteria) for segregated fund guarantees.
- A standard approach will continue to be used for all other risks by companies. That is, all companies will be required to use the same methodology and factors to determine the minimum regulatory capital requirements.
- The resulting measures will be expressed as a capital ratio similar to what exists today.

Although similar in many aspects, the new regime will differ. For example, a TAR ratio may be applied if appropriate. In the longer term, internal models may be permitted for risks in addition to segregated fund guarantees – subject to soundness, validation, governance, risk management, oversight and control criteria and standards. As noted earlier, OSFI will take an evolutionary approach to incorporating other models into the regulatory framework.

The evolution of regulatory capital requirements into a more risk sensitive framework may result in more volatile regulatory capital requirements (capital available and/or capital required). OSFI will consult with industry to assess whether that volatility provides a true reflection of the evolution of the risk and is thus "appropriate" for purposes of setting regulatory capital requirements, or whether the volatility in capital requirements amplifies the variations in risk and is thus "inappropriate."

Where necessary, OSFI will consider measures to address inappropriate volatility. For example, we will investigate options to moderate the impact of volatility on regulatory capital requirements, when:

1. For remaining long duration liabilities, markets for matching purposes do not exist, and
2. For solvency purposes, accounting/actuarial rules do not appropriately reflect the long-term characteristics of these portfolios.

Revised Regulatory Capital Requirements

Components and Structure

Revising the regulatory capital requirements includes the following work streams:

- Definition of capital
- Insurance risk
- Credit risk
- Segregated fund guarantees
- Market risk (e.g., equity, interest rate)
- Internal models approach
- Operational risk
- Risk correlation

Consultations with industry on these work streams will continue through to 2014 and are planned for implementation progressively over 2014 – 2016.

To assist with the development of these components, we are using Quantitative Impact Studies (QIS). To date, three QIS have been conducted, and two more are planned for 2012 and 2013. The main purpose of these studies is to gather information about potential methods for determining the regulatory capital requirements for market risk, credit risk, insurance risk, operational risk, risk correlation and to estimate the range of their potential impact. The approach for this analysis is based on a combination of shocks, factors and formulas.

a. Comprehensive Approach

Total Asset Requirement (TAR)

The revised regulatory capital requirements will calculate solvency buffers to determine the amount of total assets necessary to discharge the insurer's obligations under stress scenarios. The buffers should be sufficient, at a high confidence level, for the insurer to pay all claims from policyholders and senior creditors. The total assets are equal to 1) the estimate of its policyholder obligations and other liabilities plus 2) solvency buffers, both calculated for all risks that could have a financial impact on the life insurance company.

One of the key principles of a TAR approach is that both expected and unexpected losses are considered in the calculation. Using insurance obligations as an example, expected losses are included in policyholder obligations for the lifetime of all the policies. Policyholder obligations would normally include a margin for uncertainty about the expected losses (typically a provision for adverse deviations or a risk margin). The margin for uncertainty is necessary as expected losses will vary from the best estimate. However, the intent of the risk margin is not to cover significant adverse conditions or unusual circumstances. Unexpected losses resulting from adverse conditions should be covered in the solvency buffers.

The estimation of the solvency buffer is the key element of the TAR approach, and is the focus of much of our ongoing development work. OSFI's preference for the determination of policyholder obligations is to continue to use the financial balances reported in the audited financial statements. However, the proposed accounting changes for insurance contracts (IFRS 4 Phase II) – in particular whether they result in volatility that could be "inappropriate" – will impact the application of the TAR approach. Modifications to the regulatory capital requirements may be necessary once the accounting standards have been finalized.

A distinct, but related, issue is how the regulatory capital requirements will be expressed. The options are either as an add-on to the liabilities (the current approach), or in a way that refers more directly to the TAR (liabilities plus solvency buffers). To a large extent, this will also depend on the outcome of the proposed accounting standards.

OSFI will co-ordinate release of a guideline for public comment and the final guideline, with developments by the IASB for the accounting of insurance contracts.

Minimum and Supervisory Target

The revised regulatory capital requirements will retain the current intervention ladders that incorporate a minimum and a supervisory target capital level. The minimum capital requirement, including any floors associated with the use of internal models, will be based on the standardized test for all companies. For the supervisory target, companies will use the standardized test or, for segregated fund guarantees, their internal model. Consistent with ORSA, companies are expected to establish their own internal capital targets.

The minimum capital requirement, including any floors associated with the use of internal models, will be based on the standardized test for all companies.

b. Capital and Risk Measurement

Ensuring Uniformity in Risk Measurement

OSFI will specify a factor or a level of confidence for minimum regulatory capital requirements that will be similar for all risks. This is desirable as it:

- Will improve consistency in risk measurement between risks and across companies
- Provides transparency with respect to the level of protection that may be provided by regulatory capital measures
- Is consistent with International Association of Insurance Supervisors (IAIS) standards
- Is required for developing objective quantitative methodologies
- Is required for determining the appropriateness of shocks or factors

When sufficient quality data are not available and it is necessary to rely more heavily on expert judgment, the level of confidence can be used as a guide for making decisions.

Under current regulatory capital requirements the supervisory target is defined, for each risk, as an addition to the policyholder obligations. However, the supervisory target is at a different (and unknown) level of confidence for each risk. Policyholder obligations are set using a principles-based approach guided by actuarial standards of practice which provide companies with some discretion in the level of their policyholder obligations. Consequently, the total (policyholder obligations plus supervisory target) results in differing confidence levels between companies for the same risk.

Under the revised minimum regulatory capital requirements, the level of solvency buffer will be defined so a more uniform confidence level for each risk can be achieved. Periodic recalibration, in light of international developments and as new data becomes available, will be done to maintain consistency over time.

It is not possible or desirable to build a regulatory framework that provides a 100% guarantee that no life insurance company will ever fail or that policyholders and senior creditors will be paid 100 cents on the dollar. It is also not reasonable to require insurers to hold sufficient capital to cover extremely devastating

The goal of the revised regulatory framework is to strike a reasonable balance between protection for policyholders/creditors and competition.

yet highly unlikely events. When determining the amount of the TAR, there is a trade-off between the level of protection and the cost of capital. The higher the level of protection, the higher the cost will be for policyholders and, to a certain extent, the Canadian financial system as a whole. The goal of the revised regulatory framework is to strike a reasonable balance between protection (for policyholders/creditors) and competition.

Some jurisdictions are converging toward a level of protection expressed as either a Conditional Tail Expectation of 99% (CTE 99) or Value at Risk of 99.5% (VAR 99.5), two measures that are believed to offer a similar level of protection.

The level of protection being tested by OSFI in QIS 3 is for each risk separately to cover a 1-in-200 year event (a rare, but plausible scenario) over a one-year time horizon. OSFI believes this level of protection would be equivalent to the low end of the investment grade range. An adequate provision after one year is defined as the amount of assets required for the insurer to either fulfil its policyholders' and senior creditors' obligations over the remaining lifetime of the obligations or to transfer them to another company.

The use of a one-year time horizon provides for the development of stress scenarios that are relatively easy to calculate and to explain. Developing stress scenarios over multi-year time horizons would present a number of challenges. Using longer time horizons provides a similar level of protection but can lead to over-reliance on judgment due to greater uncertainty and is inconsistent with expectations for objectivity.

OSFI will use a CTE 99 over one year for the Supervisory Target level. The minimum level would be determined in a similar fashion but at a lower level of confidence, yet to be determined.

Segregated Fund Guarantees

The current approach to determining liability and regulatory capital requirements for financial guarantees embedded in segregated fund products has the following drawbacks:

- It can produce values that are materially lower than the cost of hedging.
- The models used for business written prior to 2011 are based on the equity return experience of the period 1956 – 1999, whereas the requirements for business written from 2011 onwards are based on equity returns from the 1930s to the present.
- The TAR for business written prior to 2011 was generally very small at the time a contract was written but increased rapidly following a significant decline in the markets, as happened in 2008 (which compounds financial stress).

In 2008, OSFI introduced an Alternative Method for determining regulatory capital requirements for segregated fund guarantees in order to mitigate the impact of significant short-term changes in segregated fund guarantee requirements and recognize that segregated fund guarantees are generally long-term contracts. Under the Alternative Method, the regulatory capital requirement is higher for contracts with less than five years to maturity and lower for contracts with more than five years to maturity.

The ultimate goal is to develop a methodology that measures risk appropriately, aligns capital and hedging incentives, and encourages the establishment of solvency buffers well before an adverse economic event occurs.

In 2009, OSFI initiated a comprehensive review of the methods used to determine regulatory capital requirements for segregated fund guarantee risk. It was initiated to determine what the gaps were in the existing methodology and what could be done to address them. The ultimate goal is to develop a methodology that measures risk appropriately, aligns capital and hedging incentives, and encourages the establishment of solvency buffers well before an adverse economic event occurs. From this work, OSFI decided to develop regulatory capital requirements for segregated fund guarantee risks using principles that are market consistent. For example, a market consistent principle would be to use market values where they exist and are credible. The result will be a more market consistent approach to determining regulatory capital requirements.

Under a more market consistent approach, supervisory target capital levels may be more volatile, particularly for unmitigated positions. The approach also has the potential for regulatory capital requirements to be higher than under the current framework.

Recognizing that development of the new approach based on market consistent principles would take several years to complete, OSFI decided to update the calibration criteria for the investment return models used to determine segregated fund guarantee requirements to be applied only to business written after January 1, 2011. The revised model calibration criteria are based on 80 years of equity return experience, including return experience since 1999 and during the 1930s.

The key issues to be considered under a more market consistent approach are:

- The extent to which it encourages the establishment of capital buffers well before an adverse event
- The volatility of regulatory capital requirements
- The size of any increase in regulatory capital requirements for the segregated fund guarantee business as a whole
- The extent to which hedges or other forms of risk mitigation are recognized
- The extent to which the requirements for in-force exposures are transitioned

Implementation of the new approach is expected to occur in 2016, with parallel results being produced during 2015. OSFI is consulting extensively with insurance companies and other industry stakeholders through the MCCSR Advisory Committee.

Going and Gone Concern

It is sometimes argued that the capital of a life insurance company is sufficient if it covers all the obligations a company has to its policyholders and creditors. Implicit in this view is the fact that the insurance company may not have enough resources to continue to be viable but because of the long-term nature of its obligations to policyholders, it could discharge its obligations over time (run-off) or transfer them to another company. In contrast, a much larger proportion of the obligations of banks can be withdrawn in the very short term; that is, a bank is more exposed to a short-term failure than a life insurance company.

Regulatory capital requirements exist to ensure that sufficient quantity and quality of assets are available to provide for an orderly transfer of the remaining obligations to another insurer or to run-off the remaining obligations should insolvency occur (gone concern).

OSFI's role is not only to protect policyholders and creditors in an insolvency scenario, but also to promote a regulatory framework that encourages companies to be able to withstand severe, but plausible, stress conditions.

OSFI's role is not only to protect policyholders and creditors in an insolvency scenario, but also to promote a regulatory framework that encourages companies to be able to withstand severe, but plausible, stress conditions while remaining viable (going concern).

A going concern approach requires a different level and quality of capital instruments. Traditionally, stakeholders in the life insurance industry have placed a greater focus on total capital rather than tier 1 capital. The greater emphasis on total capital is justified for the protection of policyholders and senior creditors because the traditional life insurance business is not vulnerable to liquidity runs from policyholders.

Excessive gone concern capital levels could result in an inability to earn an acceptable return on capital or increase the probability of insolvency through substantial fixed charges against earnings (interest on subordinated debt). Insufficient total capital levels could result in losses to policyholders and senior creditors in times of stress.

OSFI believes that high quality capital instruments should form a substantial part of the capital resources of an insurer when times are good. This provides the company, and OSFI, with the flexibility to respond in a constructive way in times of stress.

OSFI will consider these elements in developing guidance for the level and quality of available capital in the revised regulatory capital requirements.

The review of the definition of capital component is necessary to incorporate lessons learned during the recent financial crisis.

Definition of Capital

OSFI's revised regulatory capital requirements include a review of all elements, including the definition of available capital.

The review of the definition of capital component is necessary to incorporate lessons learned during the recent financial crisis. These relate to the quality of certain capital instruments during periods of stress, the appropriateness of deductions and adjustments made to regulatory capital. The review provides an opportunity to consider each available capital element and assess its contribution to two goals: financial strength and protection of policyholders and creditors. Revisions will provide increased transparency with respect to the meaning and purpose of both total (protection of policyholders and senior creditors) and tier 1 (financial strength) capital elements.

OSFI believes going concern capital (tier 1) should be largely comprised of equity (common and perpetual preferred shares). Items not considered to be readily available to absorb losses in a stress scenario (i.e., not fungible, not permanent, introduce an element of double-counting) should be deducted from it. Going concern capital is important to support ongoing insurer viability over the longer term given the longer-term nature of the life insurance business.

Gone concern capital (total) helps ensure that policyholders and senior creditors can be paid when the insurer is in winding-up mode. Gone concern capital may include forms of lower-quality "additional" capital components, such as hybrids and subordinated debt instruments that meet minimum quality criteria.

OSFI plans to issue a draft Definition of Capital paper for public consultation in late 2012 or early 2013.

Operational Risk

OSFI plans to introduce an explicit operational risk component when revising the regulatory capital requirements. Currently, operational risk is taken into account indirectly by an add-on (a higher capital multiple) to the requirements calculated for other risks. The goal of a distinct operational risk charge is to introduce a relatively simple measure to reflect the multiple dimensions of operational risk of an insurer's activities.

Broader guidance relating to OSFI's expectations as they relate to effective operational risk management will also be developed.

QIS 4, scheduled for summer 2012, will include consideration of operational risk.

OSFI plans to issue a draft paper on the operational risk component for public consultation. Consultation papers on operational risk management are expected to be issued in late 2012.

c. Diversification and Hedging

Diversification Benefits

Life insurance policies are subject to many different risks (interest rates, mortality, longevity, etc.).

When regulatory capital requirements are calculated separately for each risk and the results summed, the result can be a requirement that is greater than the amount that would be determined if the capital requirement for the collection of risks were determined in a single calculation using the same confidence level. Therefore, to provide appropriate incentives for companies to maintain diversified books of business, and to avoid concentration in one or two risks, some adjustment to the calculated capital requirement is needed. This adjustment is commonly referred to as a "diversification credit."

Many jurisdictions provide some diversification credit in their regulatory capital requirements. However, OSFI's current regulatory capital requirements do not allow credit for diversification of risks (except for mortality and morbidity). OSFI expects to include adjustments to regulatory capital requirements in the revised regulatory regime to address this issue. OSFI will develop principles and approaches, in consultation with stakeholders, to take into consideration risk aggregation, diversification and concentration.

OSFI plans to test diversification alternatives in QIS 4, to be issued later in 2012.

Recognition of Hedging

Hedging is a risk mitigation technique in which a company enters into additional risk positions for the purpose of altering the risk profile of a particular portfolio or the company's business as a whole. Hedges are currently recognized in a number of ways in the regulatory capital requirements.

Under OSFI's policy on the recognition of hedge contracts in the determination of regulatory capital requirements for segregated fund guarantees, companies may recognize hedge contracts in effect as of the valuation date, subject to OSFI approval, but may not recognize contracts that have not been entered into as of the valuation date.

There are two ways in which hedges of segregated fund guarantee risk can currently be recognized:

1. The hedge contracts can be combined with the segregated fund guarantee risk exposure and the regulatory capital requirement for the resulting combination can be determined.
2. The hedge contracts can be combined with other financial instruments (e.g., equities, futures contracts, options contracts) which are different from the segregated fund guarantee risk exposure, and a capital requirement for the resulting combination can be determined.

The new approach to determining regulatory capital requirements for segregated fund guarantees will continue to recognize hedge contracts, in order to encourage companies to manage and price segregated

The initial focus of the segregated fund guarantees work is on determining the valuation metric for measuring the risk.

fund guarantee risk exposure appropriately. The form and amount of recognition under the new approach will be determined in consultation with industry.

The initial focus of the segregated fund guarantees work is on determining the valuation metric for measuring the risk. Once we have established how the risk should be measured, we will be in a better position to evaluate the effectiveness of various hedging strategies and to determine the extent to which hedges will be recognized under the new approach.

The timelines for this work are consistent with those of segregated fund guarantees. Implementation of the new approach is expected to occur in 2016, with parallel results during 2015.

3 Transparency of Information to Stakeholders

Good corporate governance includes providing information to stakeholders of life insurers to facilitate their understanding of an insurer's business, governance, risk measurement and risk management. This transparency allows stakeholders to make informed decisions about the company, which can play a role in promoting the accountability of the board and management.

OSFI's objective is to have transparent regulatory capital requirements. Therefore, as part of the renewal of the life insurance regulatory framework, OSFI will promote appropriate transparency of information on the financial condition of life insurance companies to support the revised framework. OSFI will allow for flexibility, where appropriate, in the format and location of insurer public communications to limit the burden on companies associated with producing the information, as long as it supports public understanding of the information disclosed.

OSFI will consult extensively with stakeholders, and will co-ordinate transparency requirements with the revisions to the regulatory framework.

4 External Challenges and Process

What are the External Challenges That May Affect This Evolving Process?

International regulatory developments impact both Canadian life insurance companies and OSFI. OSFI is monitoring the key developments and will consider them when revising the regulatory framework:

- The IASB insurance contracts project (IFRS 4 Phase II) will have a significant impact. While the extent of the impact is not fully known (and will not be until the final standard is set), OSFI is committed to consulting with industry stakeholders on how the final standard should be incorporated into the regulatory framework. Ideally, our initiatives would incorporate a final IFRS 4 Phase II standard. However, should a significant delay occur in the IASB work, OSFI will continue to move its work forward using current international financial reporting standards.
- Other IFRS changes: any changes to IFRS are of importance to OSFI, as well as to insurers. OSFI recognizes that the objectives of the accounting standards may not always be aligned with our regulatory objectives. Consequently, OSFI reviews relevant IASB proposals for changes to assess the degree to which they could impact regulatory capital requirements or other elements of the regulatory framework. In consultation with industry, OSFI will assess whether adjustments are required in the regulatory framework to reduce unintended consequences.
- The Financial Stability Board (FSB) and IAIS are currently examining whether large insurance companies are systemically important (Global Systemically Important Insurers – G-SII) and, if so, what prudential supervision should be adjusted accordingly. Although we expect no Canadian life insurance company would be a G-SII, there may be lessons learned that suggest refinements to the revised regulatory framework. This IAIS work is expected to be completed in early 2013. Subsequent to that (late 2013/early 2014), OSFI will consult with industry as we develop a point of view on domestic SIIs.
- The IAIS is also working on the development of a common framework (ComFrame) for the supervision of internationally active insurance groups. Although this primarily affects the supervision of insurance groups, there may be some impact on the regulatory framework which we will need to incorporate.

OSFI encourages stakeholder participation in the regulatory review process, and as such, will continue, through various forums to facilitate communication on our initiatives and progress.

What is Our Process to Mitigate These Challenges?

To help ensure that regulatory framework changes meet the future expectations of all stakeholders involved, it is essential to engage with them about the direction and consequences of the changes. Reform of the regulatory framework cannot and should not respond as quickly as industry does to change, which is why OSFI seeks to make the regulatory framework flexible enough to allow innovation, yet firm enough to set standards across the industry to ensure policyholder and creditor protection.

OSFI encourages stakeholder participation in the regulatory review process, and as such, will continue, through various forums (life insurance advisory committees, meetings with industry organizations, etc.) to facilitate communication on our initiatives and progress. OSFI will continue to issue draft guidance for public comment. We will also provide summaries of comments received, with descriptions of those comments that have been incorporated into the guidance, as well as our rationale for those comments that have not been accepted.

We will continue to use QIS to gather information and test alternatives where appropriate. To date, three QISs have been conducted and two more are planned to be conducted in 2012 and 2013. These QISs will help to refine and calibrate the guidance discussed above.

Insurance companies and other key stakeholders (Autorité des marchés financiers (AMF), Assuris, Canadian Institute of Actuaries, CLHIA, etc.) have been, and continue to be, consulted in the development of the revised regulatory framework. For example, the MCCSR Advisory Committee (MAC) is composed of OSFI, company representatives and other stakeholders; and the Standard Approach Advisory Group (SAAG) is composed of OSFI, AMF, Assuris and others.

There are other important considerations in both developing and implementing a revised regulatory framework that influences OSFI's thinking:

- Companies offer long-term products, often without the ability to re-price these products; changing the regulatory capital requirements impacts the profitability of these products. Thus, transitional measures may be appropriate.
- The life insurance business model is in many ways much different than other financial institutions, like banks; consequently, elements of the regulatory framework should reflect these differences. On the other hand, where there are no differences, similar regulatory requirements are appropriate.
- The regulatory framework may create competitive issues in markets in other jurisdictions for some companies.

Annex A – Timelines

Calendar Years/ Quarters	2007	2008	2009	2010	2011				2012				2013				2014	2015	2016	2017
Work Streams					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
Regulatory Framework																				
Vision and Concepts	✚ ♦	♦		♦								●			■	♦	▲	▲		
ORSA						✚								●		♦	▲			
Definition of Capital					✚										■	●	♦	▲		
Transparency											✚					●	♦	▲		
Risk Correlation							✚				■				■	●	♦	▲		
Regulatory Capital Requirements – Standard Approach																				
Credit		✚	■				■				■				■	●	♦	▲		
Market		✚ ●	■	■			■				■				■	●	♦	▲		
Insurance							✚ ■				■				■	●	♦	▲		
Operational							✚				■				■	●	♦	▲		
Segregated Funds												✚			■	●	♦	▲		
Regulatory Capital Requirements – Internal Model Approach																				
Segregated Funds			✚	■ ♦												● ■	●	♦	▲	
Other Risks																			✚	

✚ Project Initiation ● Public Consultation ■ Quantitative Impact Study ▲ Implementation Milestone ♦ Final Guideline Issued

Project Time Frame Work has Not Commenced or in Abeyance

OSFI-BSIF.gc.ca

OSFI
BSIF