Advisory

Title	Recognition of Hedge Contracts in the Determination of the Segregated Fund Guarantee Capital Requirement for Life Insurance Companies
Category	Capital Adequacy Requirements
Date	December 31, 2008
Sector	Life Insurance and Fraternal Companies

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Guidance or document to be rescinded

As a result of OSFI's Policy Modernization efforts, this guidance or document was identified as outdated, redundant, or no longer aligns with our mandate. It will be rescinded and removed from the website by December 31, 2025.

Note:

Advisories describe how OSFI administers and interprets provisions of existing legislation, regulations or guidelines, or provide OSFI’s position regarding certain policy issues. Advisories are not law; readers should refer to the relevant provisions of the legislation, regulation or guideline, including any amendments that came into effect subsequent to the Advisory’s publication, when considering the relevancy of the Advisory.

This Advisory clarifies OSFI policy with respect to recognition of hedge contracts in the determination of the segregated fund guarantee regulatory capital requirement for life insurance companies. It complements the following OSFI guidance:

- Guideline A: *Life Insurance Capital Adequacy Test* (LICAT), and
- March 2002 Instruction Guide: *Use of Internal Models for Determining Required Capital for Segregated Fund Risks* (LICAT).

Definitions

For the purposes of this advisory, the term *hedge contracts* is defined as follows:

Hedge Contracts: Positions in financial instruments or derivatives, such as forwards, futures, swaps or options, whether purchased or sold, undertaken through a securities exchange or over-the-counter primarily for the purpose of managing or mitigating segregated fund guarantee risk.

Policy on the Recognition of Hedge Contracts

OSFI encourages companies with material segregated fund guarantee risk exposure to develop and implement plans for managing this risk. These plans should take into consideration the company's appetite for segregated fund guarantee risk and include mechanisms for monitoring and mitigating this risk.

There are a number of different strategies for managing and mitigating segregated fund guarantee risk, among them strategies that involve the use of hedge contracts. Although companies may wish to implement, for their own internal risk management purposes, forward- looking strategies that involve the anticipated use of hedge contracts, the only hedge contracts that will be considered for recognition in the determination of a company's segregated fund guarantee regulatory capital requirement are the hedge contracts that the company holds as of the valuation date. Hedge contracts that the company has not yet entered into as of the valuation date will not be recognized in the determination of the company's segregated fund guarantee regulatory capital requirement. In particular, no recognition will be given for:

- anticipated rollovers or renewals of hedge contracts,
- hedge contracts expected to be entered into subsequent to the valuation date for the purpose of rebalancing a hedge position,
- hedge contracts that the company's risk management policy states would be entered into contingent upon the occurrence of particular future events, or
- any form of management action subsequent to the valuation date.

Explicit approval from OSFI is required before a company may recognize any hedge contracts in the determination of the company's segregated fund guarantee regulatory capital requirement. Updated guidance on the requirements that a company must meet to be eligible for approval and information on the application procedure will be provided in a subsequent notice.

The amount of recognition that a company's hedge contracts receive will be determined at the time of approval and will depend in part on:

- the derivative or financial instruments used to implement the hedge, e.g., options, futures, swaps, etc, and their relationship to the underlying segregated fund guarantee risk,
- the residual risks, i.e., risks that are not hedged,
- the demonstrated effectiveness of the hedge contracts,
- new risks introduced as a result of the hedge contracts, and
- the effectiveness of the company's overall risk management infrastructure.

Over-the-counter hedge contracts will remain subject to the charges for counterparty credit risk specified in chapter 4 of the LICAT guideline.

In the absence of approval, the provisions of section 5.2.3 of the LICAT guideline will continue to apply. Note that according to the provisions of section 5.2.3, no additional capital for equity market risk is required for purchased put options that clearly serve to hedge the company's segregated fund guarantee risk. Moreover, where a company has both long and short positions in exactly the same underlying equity security, the capital requirement under section 5.2.4 is based on the company's net position in the equity security.